CURRENT BUSINESS FAILURE EPIDEMIC

HEARING

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

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CURRENT BUSINESS FAILURE EPIDEMIC

WEDNESDAY, JUNE 23, 1982

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL OVERSIGHT,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LaFALCE

Mr. LAFALCE. The subcommittee will come to order.

The House Small Business General Oversight Subcommittee is holding hearings on today's business failure epidemic and its devastating toll on small business. As we meet, the deep recession that began last June confronts American business with its gravest crisis since the Great Depression. This is what we see:

Capital investment by companies is off sharply. Data Resources, Inc., forecasts that business investment will be off 8 percent this year over last year, despite the massive tax incentives to invest enacted last year.

After-tax profits of corporations in the first months of 1982 were almost one-third lower than a year earlier, the sharpest drop in the postwar period.

Many companies are saddled with heavy short-term debt. The ratio of short-term debt to total debt is at a new high. Business balance sheets and corporate liquidity are more fragile than at any other time in postwar history.

Since the first quarter of 1981, industrial output has dropped 7 percent. Our Nation's factories ran at a dismal 70.8 percent of capacity in May of this year, almost 15 percentage points below the rate at which capital goods makers start getting orders for equipment to add capacity.

Small business proprietorship income is expected to be nearly 15 percent lower this year than in 1980, according to Data Resources, Inc.

And businesses are failing at a rate not seen since the Great Depression of 50 years ago.

Today's figures as reported by Dun & Bradstreet are truly alarming. The failure rate today is almost 90 per 10,000 companies, just short of the failure rate of 100 per 10,000 companies recorded in the Great Depression year of 1933. Put another way, 11 businesses are failing right now for every hour of the business day.

In the past 2 years, the business failure rate has jumped 110 percent, the second sharpest 2-year jump since 1920. The only time it was higher was in the 2 years immediately after World War II, when business failures returned from the depressed war level to normal. Dun & Bradstreet tells us that 11,742 companies, or 42 per 10,000 companies, failed in 1980. As we will hear this morning, we can expect at least 25,000 companies to fail this year and to see the business failure rate of 1933 reached or topped this year.

These are, indeed, grim figures. We should remember that the Dun & Bradstreet figures cover only failures which involve losses to creditors. The number of business failures today is really much higher since thousands of businessmen simply decide to close their businesses because they see only an unprofitable future. These business closings, which are really failures, reflect a lack of confidence in the business environment and are not reflected in Dun & Bradstreet's statistics. Nevertheless, as President Reagan's recently released report on the state of small business tells us, the Dun & Bradstreet figures are a valuable indicator of business distress.

It is this distress that we will examine this morning. We will focus not only on the numbers; we will also look at the human dimension of this great tradgedy. We must not forget that today's business failures mean lost jobs, ruined lives, and dashed dreams. They mean lost pensions, lost life savings, and lost tax revenues. They also take a human toll in the lost self-esteem felt by those directly affected. They mean an end to the American dream of opportunity and owning one's own business that has been such a powerful part of this Nation's dynamism.

Last March, when it was becoming clear that 1982 would see a record number of business failures, I wrote to two dozen U.S. bankruptcy judges and U.S. trustees to find out why this was happening. I wanted to hear directly from them because they are seeing every day what is happening, why it is happening, and what needs to be done to end this terrible spiral of failures. I received 19 replies from throughout the Nation. This is the picture that emerged from the letters:

Businesses are failing in all sections of the country and in every economic sector.

Large and small businesses, and young and old businesses, are failing.

Businesses are failing in record numbers, and the record failure continues to rise.

The business failures experienced today are much worse than those experienced during the last severe recession of 1974–75.

Businesses are failing today because of high interest rates.

Let me read a few of the responses:

U.S. Bankruptcy Judge Peter M. Elliott, of Los Angeles, wrote:

"I would say that the major cause of small business failures is high interest rates."

U.S. Trustee William P. Westphal, Sr., of Minneapolis, wrote:

The two primary causes for the increase in bankruptcies generally, as well as for small business in particular, are the extremely high interest rates and the length of the current recession.

U.S. Trustee Scott H. Bush, of Dallas, wrote:

The tentacles of the current recession reach to all communities, at all locations. Even the glorious Sun Belt has not been insulated. The current recession is much more severe than the 1974–75 recession.

U. S. Bankruptcy Judge Charles B. McCormick, of Chicago, wrote:

The increase in small business bankruptcy filings must, I feel, be blamed on the common elements of high interest, tight money, inflation, the loss of jobs due to plant closings and the farming out of work to foreign countries and the other ills that greet one in the media every day.

U.S. Bankruptcy Judge William L. Norton, Jr., of Atlanta wrote:

I do not see incompetency or mismanagement or dishonest actions in individuals or businessmen, which some credit grantors or others ascribe to debtors in the Bankruptcy Court, as being the cause or prevalence in bankruptcies. I see the overwhelming number of individuals and business debtors in this court who sincerely and honestly want to pay their debts and have been and are attempting to pay such debts. I see many businesses and persons in my court who I feel: there, but for the grace of God, go I.

As the excerpts from the letters I have read show, high interest rates are placing an extraordinarily heavy burden on small business. This is unfair. Small business relies almost exclusively on banks for financing. They cannot shop around or bargain for the best interest rates, as can large corporations. Many small businesses are paying at least prime or above prime for their loans. That means over 16½ percent interest. In real terms, the interest rate is at least 10 percent, the highest in recent memory.

Many businesses are being swallowed up by the high real interest rates we have experienced for the past year. This should come as no surprise. Many economists have been warning that it is only a matter of time before many more small businesses succumb to these rates.

Our witnesses this morning will discuss these problems and the policies that are required to end the devastation of all business and small business in particular. We will hear from a leading academic who is an expert in predicting business failures; the corporate economist and chief statistician of Dun & Bradstreet; a spokesman for the small business community; and a panel of U.S. bankruptcy judges and trustees.

They will give us the diverse insights that are so essential in this time of crisis.

[Representative J. William Stanton's opening statement follows:]

OPENING STATEMENT OF HON. J. WILLIAM STANTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

I would like to thank you for calling this hearing this morning on such an important subject. The shocking statistics on small business failures in this country during the past year indicate that there is something terribly wrong in the way our economy is functioning.

Small business is the backbone of this Nation. It constitutes 95 percent of our businesses, 86 percent of new jobs created and over half the gross national product. As you are well aware, having borne the major burden of the floor debate on the Small Business Innovative Research bill, small business is having a tough time even in Congress which is supposed to be responsible to the needs of all of our citizens. When a bill as innocuous as the SBIR legislation, mandating that a little more than 1 percent of our total Federal research and development funds go to small business requires more than 2 legislative days of fighting to get through Congress, you know small business is in trouble!

Mr. Chairman, we all know the reasons for such suffering are many, and I suspect we will be hearing a great deal of evidence today which will suggest that small business is just not being given a fair shake in the marketplace. High interest rates discriminate against the small businessman who cannot get access to capital at the same rate that large corporations can. Tax incentives favor the business that is well established and making a profit. Federal procurement policies tend to seek out the businesses that can tailor their products and services to meet complicated and multiple demands rather than those that can do the job most economically.

I commend the purpose of these hearings and look forward to hearing some recommendations from these witnesses that will help us get to the root of the problem and come up with solutions that can provide some guidance to assist small business through any legislative means at our disposal in order to improve the conditions under which they function, and thereby help our Nation back to a stronger, healthier condition.

Mr. LAFALCE. I am pleased that Congressman Buddy Roemer from Louisiana, who has been of such tremendous assistance to this subcommittee in all of its endeavors, is here this morning and I wonder if he has any comments he would like to make.

OPENING STATEMENT OF HON. BUDDY ROEMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. ROEMER. A brief comment, Mr. Chairman, and it is one of praise for you having these hearings at all. It is obvious that high interest rates are the chief, but not the only, cause of the extraordinary high rate of failure among small businesses and businesses in general. I don't think these hearings could come at a better time, asking the basic question: Why are interest rates so high and what could and should the administration be doing to lower them, and what should Congress be doing and could be doing to lower them? So, I appreciate the hearings and I thank you for your leadership, Mr. Chairman.

Mr. LAFALCE. Thank you very much, Congressman.

We will now hear from Prof. Edward I. Altman, of New York University.

Professor Altman.

Professor, we will include the entire text of your prepared testimony in the body of the record and you may proceed to summarize it.

TESTIMONY OF DR. EDWARD I. ALTMAN, PROFESSOR OF FINANCE, AND CHAIRMAN, MBA PROGRAM, NEW YORK UNIVERSITY, NEW YORK, N.Y.

Dr. ALTMAN. Thank you, Mr. Chairman.

I think what I would like to do is read parts of it and speak extemporaneously about parts of it. There are a number of charts available in the text, which are available on the table there for the audience to refer to.

I am pleased to appear before this subcommittee today to discuss my views on the current condition of U.S. corporations and particularly the dramatic increase in the rate of business failures and bankruptcies in the economy. My remarks will embrace firms of all sizes, although I am aware that this particular subcommittee has a special interest, and is most concerned with the plight of small businesses and the outlook for them as well.

The purposes of my statement is to comment on: Why business entities are failing at rates unprecedented since the Great Depres-

sion years; the impact of both macroeconomic and microeconomic influences on business failures; my predictions of the business failure rate and the number of bankruptcies for the latter part of 1982; and finally, the overall implications of the current surge of business failures.

Most of the reasons why firms of all sizes are failing at unprecedented rates will come as no surprise to even the most casual observer of economic events in the last 2 or 3 years. The reasons that we are witnessing such a dramatic increase in business failures are that many negative factors and influences are simultaneously impacting the economy and have been doing so for a sustained period of time. The pressures that have been building for a long period of time now have been doing so for several years and we need a break from these pressures. More importantly, the break must be a sustainable one, not one similar to the break that we thought we had in the latter part of 1980.

I was predicting a dramatic increase in the rate of failures as early as March 1980 in a Business Week article of March 24, 1980. The outlook for 1982 is for a continued increase over 1981. Indeed, your earlier comments attest to the fact that the business failure rate is already currently at a rate close to 90 per 10,000 firms, which is just slightly under the rate of 100 per 10,000 firms of 1933.

Indeed, for the week ending June 11, 1982, there were 532 failures. This was a 70.5-percent increase over the comparable week in 1981 and the highest single week's business failures in 50 years. The number of individual bankruptcy filings for fiscal 1982 is already over 50,000 firms.

While business failure is a more general description of financial distress, the population of firms covered by Dun & Bradstreet is considerably less than those entities which can petition the courts for bankruptcy and reorganization. Hence, the latter figures, namely, the bankruptcy figures, are far greater than the figures for business failures and I will return to my forecast shortly.

Beset by the sluggish economy and sustained recession since 1980, with sharply declining profits and burdened by continuing high interest rates, the financial health of the business community has experienced overt deterioration. The stage for this deterioration has been set over the last 5 to 6 years as balance sheets have become less liquid and far more risky, especially in terms of the percentage of operations financed by debt.

Growing expectations of inflation in the late 1970's and early 1980's encouraged businesses to expand and to take risks, which were not wise. Today, as always, the primary cause of business failure is managerially related. However, the margin of error today is so much smaller than it has been in several decades.

There is a growing realization that firms must cut back on unprofitable operations and concentrate on those lines which they know best. Unfortunately for the small firm, however, there is little it can do in terms of cutbacks.

It should be emphasized that the current failure rate and the outlook for the next several quarters is not only a small business problem. It is also very important to understand the impact of large business failures on the small business. You can't just look at the small business numbers and say that is the issue we are con-

cerned with, because if the large business failures increase—as they appear to be—then that impact on creditors and debtors alike will have a severe potential impact on small businesses.

In the last 2 months, we have seen four firms with liabilities of over $500 million succumb to the economic reality of business failure and petition for bankruptcy reorganization. Indeed, table 1 of my testimony lists 36 companies with liabilities greater than $125 million, which have filed for bankruptcy since 1970.

Prior to 1980, these large firm bankruptcies were found predominantly among railroads, retailers, and real estate investment trusts. The economic problems today are found, however, on a broad cross section of firms, including the manufacturing sector—the heart of our industrial activity. As manufacturing and construction firms begin to fail in greater numbers, the servicing firms that deal with these companies will also suffer greatly.

Chart 2 of my analysis shows a dramatic increase in business bankruptcy filings since 1978. I would like to make a comment on business bankruptcy filings, if I may, which is perhaps a little off the primary subject of this particular subcommittee, but a related one.

In my opinion, the accusation that the new Bankruptcy Code, which went into effect October 1979, has been blamed for some of these failures is not true. I do not believe the fact that we have a new Bankruptcy Code can explain the record number of business filings. The causes are much more fundamental than that. They are the negative powerful forces combining, from 1980 to 1982, to cause the greatest threat to firm viability since the Great Depression. I refer to the sustained economic malaise of the economy, which has continued virtually without abatement, combined with the deterioration in firm liquidity, increased leverage and dramatically reduced coverage of financial payments of interest and principal.

These arguments are summarized in my charts 3 through 6. Very briefly, chart 3 shows liquid assets as a percentage of current liabilities have decreased from 30 percent to almost 20 percent since 1976. The ratio of liabilities to total assets has increased over the same period and perhaps the most revealing trend statistic is indicated in chart 5.

In chart 5 we observe that the net interest payments as a percentage of income from nonfinancial corporations has increased from approximately 20 cents of every $1 of income earned in 1978 to over 40 cents per $1 of earnings in 1981. No doubt, the primary cause of the increase of this statistic is the record high interest rates that firms are now paying. If the average firm pays out in interest over 40 percent of every $1 earned before interest and taxes, no wonder we have so many marginal firms succumbing to the economic reality of bankruptcy. The small and young firm is particularly vulnerable today. The firm which financed its growth with debt capital in the mid to late seventies has been faced with the unfortunate necessity of refinancing its short-term loans with new loans at record interest rates. The small firm does not typically have access to the long-term debt markets or to equity markets.

Most short-term loans for risky companies are part of a revolving agreement or line of credit agreement with financial institutions

where the interest rate paid is based on the prime rate plus a premium of 3 to 5 percent. A loan costing 10 percent in 1976–77 is now in June 1982 costing approximately 20 percent, and has been as high as 23 to 25 percent in recent years.

Even more important—the chart shown to the chairman's left on real interest rates—reveals that the real interest rate currently is in the 10- to 15-percent range, whereas when these firms first took out their short-term loans, the real interest rate was barely above zero. The real interest rate is the difference between the nominal rate paid minus the inflation rate.

The diminution in the inflation is a mixed blessing in some segments of the economy, particularly the small firm. I might add, incidentally, that banks play a very important role in these small firm failures or continuing operations—and to give credit where credit is due—I think that the banks are continuing to supply credit to small marginal firms. How long they will do so in the future, I don't know.

The essence is that the business failure rate would even be higher in 1982 if financial institutions felt that they would be better off forcing small firms into liquidation. They are not philanthropic. They will not force a firm into failure unless they feel that they are better off in liquidation than to continue the operation. How much longer they will continue to support firms, even at these high interest rates, is debatable.

Now, there is one important factor, which I don't think many people realize, that has also contributed to the business failure rate increase: That is the fact that most firms fail between the ages of 2 and 5 years of their life, with the peak in the third and fourth year. During the 2- to 5-year-age period, over 50 percent of all firms that do fail, fail then.

Charts 7 and 8 show a very interesting series of statistics that took place in the 1977–79 period. In that period, the business formation rate in the United States rose dramatically. In 1979, there were 525,000 net new businesses. If we observe the failure rate experience, which shows that age of firms are very much related to failures, we will now expect that the number of business failures, particularly the young, small firm, will not only have increased in the 1980, 1981, and 1982 period, but it is likely to continue to increase in 1983 and 1984, regardless of what happens in the economy. That is simply because the statistics show that as the firm is young, it is much more vulnerable. In an economic malaise period that vulnerability is going to be an even greater factor.

I have been referring to aggregate economic influences on business failures and to an econometric model that I built, which attempts to predict business failures in the economy. Now maybe I am a little out of date here because the resulting model that I used to forecast failures for 1982 was performed in 1981. That forecast was for the business failure rate to be 79 per 10,000 in 1982. That would have been the highest failure rate since 1933. However, the malaise of the economy has not abated as was predicted by experts and, as a result, the failure rate as Mr. LaFalce mentioned is now probably close to 90 per 10,000.

In other words, I have underestimated the financial plight of businesses in general, and particularly the small firms.

The last thing I would like to mention in terms of forecasts is based on a microeconomic model that I built that looks at individual firm financial characteristics in order to forecast the likelihood of bankruptcy of these firms. The name of this approach is known as the Z-Score approach, which is now quite commonly found in academic textbooks and is used quite frequently by financial institutions and firms themselves. This technique combines classical financial ratio analysis with a multivariate statistical procedure in order to increase the information content of those numbers.

A number of indicators are objectively weighted. Therefore, it is not a subjective approach on my part. It is an objectively weighted "screen," which looks at the financial profiles of firms today. I am not going to go through the model itself. It is in my prepared remarks. You can "play around" with it yourselves, perhaps on your own individual companies, if you are interested. What I am mainly interested in talking about is to analyze the largest 2,000 manufacturing firms in the United States today by this technique and the implications for the small firms will become apparent afterward.

If we apply the model to the largest 2,000 firms in the United States today, 3.7 percent, or 78, of those largest firms have an overall risk profile indicating a significantly high probability of failure. Almost 10 percent of that number, that is 200 of the largest 2,000 firms—I am not talking about small firms—have a financial profile, which is extremely vulnerable. I call that "at risk," 200 out of 2,000. This compares with only 7 percent as of yearend 1980. In a little over 1 year, therefore, the number of firms at risk in the economy has increased by about one-third.

I have not applied the Z-Score model to small firms and privately held firms. The main reason is I don't have the data, but my guess is that if we applied the Z-Score model to small firms in the economy, that at least 15 percent of the firms out there would have financial profiles which are similar to bankrupt firms of the past. I am sorry that I do not have that data for you in quantitative terms because the data is simply not available in any great amounts.

The implications are, indeed, that these are difficult economic times. Unless the economy improves and interest rates decline significantly, I am afraid that the already staggering number of business failures will swell to levels comparable to the early thirties. Again, maybe I am a little out of date there because they are approaching that rate already. One risk is that the record numbers will themselves cause creditor and debtor behavior which will contribute further to financial distress. If banks ration credit to only the most credit-worthy firms, the marginal firms will stand little chance of surviving. It is also probably true that the marginal firm is oftentimes a small firm.

I would like to emphasize this next point. The real risk is not whether the economy will turn around and stage a recovery. The real risk is how long will the recovery last. If the turnaround is relatively short, like the one we experienced in late 1980, then thousands of firms, particularly small ones, will not have sufficient time to get back on their feet to a positive cash flow position.

I go through, in the written testimony, a number of positive and negative things going on in the economy today; negative being 70 percent is the current operating capacity rate of U.S. companies

and, therefore, we need a sustained growth, not just a shot in the arm, for bringing that operating level up so that new investment will be generated; not just the inventory type of growth, which is probably on the scene already.

The economic outlook for most firms is not encouraging. Firms, as I said, are failing at record rates. It seems, at the level we are now experiencing, that Government and private financial institution policies must address the situation directly and provide continuing credit or subsidized programs to enable the productive but marginal firm to remain a continuing entity. I want to emphasize that. I don't think we should have any sort of programs for helping firms which are not productive, which have ineffective management and which should probably fail.

I have been an outspoken opponent of bailouts for many years, and I still don't think this should be done. Only for the productive marginal firms should there be any type of subsidy or continuing credit program.

I would like to thank the subcommittee for their patience. I probably ran a little bit over the time allocated.

[Professor Altman's prepared statement with attachments follow:]

PREPARED STATEMENT OF DR. EDWARD I. ALTMAN, PROFESSOR OF FINANCE, AND CHAIRMAN, MBA PROGRAM, NEW YORK UNIVERSITY, NEW YORK, N.Y.

I am pleased to appear before this subcommittee today to discuss my views on the current condition of U.S. corporations and particularly the dramatic increase in the rate of business failures and bankruptcies in the economy. My remarks will embrace firms of all sizes although I am aware that this particular subcommittee is most concerned with the plight and outlook for small businesses.

The purposes of my statements are to comment on: (1) Why business entities are currently failing at a rate unsurpassed since the Great Depression years of the early 1930's; (2) the impact of both macroeconomic and microeconomic influences on business failures; (3) my predictions of the business failure rate and number of bankruptcies for the latter part of 1982; (4) my assessment of the bankruptcy propensity of the Nation's largest and smallest entities on an individual firm basis, and (5) the overall implications of the current surge of business failures.

CURRENT CONDITION OF THE ECONOMY

Most of the reasons why firms of all sizes are failing at unprecedented rates will come as no surprise to even the casual observer of economic events in the last 2–3 years. The reasons that we are witnessing such a dramatic increase in business failures are that many negative factors and influences are simultaneously impacting the economy and have been doing so for a sustained period of time. Headlines in newspaper articles in late 1980 and early 1981 heralded such events as "This Year's Slump Hits Weaker Concerns Harder Than Decline of 1973–75" and "Slump Devastates Small Businesses; Failures Threaten To Slow Recovery." The pressures have been building for a long time now and we need a break in these pressures and, more importantly, the break must be a sustainable one!

I was predicting a dramatic increase in the rate of failures as early as March 1980 (Business Week, March 24, 1980, pp. 98–104) and the outlook for 1982 is for a continued increase over 1981. The failure rate in the economy, as measured by Dun & Bradstreet, is likely to exceed 80 per 10,000 listed companies—the highest rate since 1933; the rate was 64 per 10,000 in 1961 and 70 per 10,000 in 1939 (see Chart 1). Indeed, for the week ending June 11, 1982, there were 532 business failures. This was a 70.5-percent increase over the comparable week in 1981 and the highest single week's total in 50 years. The number of individual business bankruptcy filings for fiscal 1982 is already over 50,000 enterprises (Chart 2). While "business failure" is a more general description of financial distress, the population of firms covered by Dun & Bradstreet is considerably less than those entities which can petition the courts for reorganization or liquidation. Hence, the latter figures are greater. I will return to the forecasts shortly.

Beset by a sustained, sluggish economy since 1980, with sharply declining profits, and burdened by continuing high interest rates, the financial health of the business community has experienced overt deterioration. The stage for this deterioration was set over the last 5 or 6 years as firm balance sheets became less liquid and more risky, especially in terms of the percentage of operations financed by debt and capitalized leases. Growing expectations of inflation in the late 1970's and early 1980's encouraged businesses to expand and to take risks which were not wise. Today, as always, the primary cause of failure is managerial related. The margin of error today, however, is so much smaller.

There is a growing realization that firms must cut back on unprofitable operations and concentrate on those lines which they know best and hopefully are most profitable. Unfortunately for the small firm, however, there is little it can do in terms of cutbacks. The devastating effects of reduced profits and high interest rates, that have remained around 20 percent or more for several years, are continuing to reduce the ranks of our smaller firm population.

I will elaborate in a moment upon another, more subtle, influence which has caused the number of young, small firms to fail in increasingly large numbers in 1981 and 1982 and is likely to be a negative influence through 1983 and possibly 1984. I refer to the dramatic increase in new business formation that we experienced in the United States in the late 1970's.

It should be emphasized that the current failure rate and the outlook for the next several quarters is not just a small firm problem, nor is it restricted to a few sectors of the economy. It is a problem for firms of all sizes and the malaise is spread across just about every area of activity. In the last 2 months, we have observed four firms with liabilities of $500 million or more petitioning the courts to reorganize under the Bankruptcy Act. There is an increasing growth in large firm vulnerability of a trend which began in 1970. Since the Penn-Central crisis, over 35 firms with liabilities exceeding $125 million have declared bankruptcy (Table 1). Prior to 1980, however, these large firm bankruptcies were found predominantly among railroads, retailers and real estate investment trusts. The economic problems can now be found in the manufacturing sector as well—the heart of our industrial sector. As manufacturing and construction related firms fail in increasing numbers, entities which service these industries will also suffer.

AGGREGATE MEASURES OF INCREASED CORPORATE FINANCIAL VULNERABILITY

Chart 2 illustrates the dramatic increase in the number of business bankruptcy filings in the United States, especially since 1978. In my opinion, the fact that the new Bankruptcy Code went into effect in October 1979 cannot explain the record number of bankruptcy filings. It is the result, however, of two fundamental, negative powerful forces combining in 1980–82 to cause the greatest threat to firm viability since the Great Depression of the 1930's. I refer to the sustained economic malaise of the economy since 1980 that had continued, virtually without abatement, to this present day, combined with the deterioration in firm liquidity, increased leverage and dramatically reduced coverage of financial payments of interest and principal.

Charts 3–6 illustrate the above arguments. Many of these charts were compiled by J. Charles Partee, for his recent statement before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs (U.S. House of Representatives, May 26, 1982). Liquid assets as a percent of current liabilities have decreased from a 1976 high of approximately 30 percent to an amount just above 20 percent in 1982 (Chart 3). The ratio of liabilities to total assets (Chart 4) has increased over this same period from a low of 54 percent in 1976 to over 57 percent in 1982 and it is not clear if these statistics include the capitalization of financial leases, which would magnify the debt/asset ratio by 15–20 percent for the average non-financial corporation. Perhaps the most revealing trend-statistic is indicated in Chart 5 where we observe that net interest payments as a percent of income for non-financial corporations has increased from approximately 20 cents for every dollar of income in 1978 to over 40 cents per dollar in 1981. No doubt the primary cause of this increase is due to the record high interest rates that firms are paying in recent years.

If the average firm pays out in interest over 40 percent of every dollar earned before interest and taxes, no wonder so many marginal firms are succumbing to the economic reality of bankruptcy.

The small and young firm is particularly vulnerable today. The firm which financed its early growth with debt capital in the mid to late 1970's has been faced with the unfortunate necessity of refinancing its short term loans with new loans at

record interest rates. The small firm does not typically have access to the long-term debt markets or even the equity markets. Chart 6 shows that, for all firms, the ratio of short term debt to total debt has increased from a low of under 35 percent in 1976 to about 42 percent in 1982. Most short term loans are part of a revolving or line of credit agreement with financial institutions where the interest rate charged is based on a floating-rate basis, e.g., the prime rate plus 3 percent. A loan costing 10 percent in 1976–77 (7 percent plus 3 percent premium for a risky loan) is costing (in 1982) approximately 20 percent and has even reached the 23–25 percent level in recent years. No wonder we have record levels of bankruptcies and business failures. Even more difficult is the real rate of interest that firms are now paying. Whereas the real rate (nominal rate-inflation rate) was close to zero in 1976–78, it is now perhaps as high as 10–15 percent. Firms simply do not have the ability to pass along their cost increases as they once did. The dimunition in the inflation rate is a mixed blessing to some segments of the economy, particularly the small firm.

In 1982, banks are more frequently requiring a string of loan covenants which are considered necessary if continued credit is to be extended to small and medium sized entities. These include controls over management's investment decisions, more frequent financial reports, extra collateral and increasingly restrictive working capital and debt/equity ratios loan covenants. These conditions, however, are seen as necessary in order for loans to be restructured and small firms permitted to stay in business. Banks have even on occasion, suspended or reduced interest payments and lengthened short term loans as competition for the small and "middle market" gets intense. Banks can usually recoup these reductions through increased fees and continued receipt of principal repayments. The essence is that the business failure rate would be even higher in 1982 if financial institutions felt that they would be better off forcing small firms into liquidation.

FAILURE RATE BY AGE AND NEW BUSINESS FORMATION

An important factor to consider that is particularly related to the small, young entity, is the failure propensity of firms according to their age. Dun & Bradstreet's statistics show that the highest failure propensity is between 2–5 years of a firm's existence, with the peak in the third and fourth years (Chart 7). During the 2–5-year age period, over 50 percent of all failures occur.

Chart 8 depicts the index of net business formation from 1970–81. Note that the years 1977–79 were particularly high business formation years with new business incorporations rising to about 525,000 in 1979 from 375,000 in 1976. Using the failure propensity by age relationships discussed above, the 1977–79 business expansion should result in an increasing number of small firm failures in the period 1980–84.

I have utilized many of the aforementioned aggregate economic influences on business failures in order to construct an econometric failure prediction model. The model incorporates the following aggregate series in order to explain historical movement in business failure rates:

(a) *Change in real GNP.*—A measure of overall economic activity.

(b) *Change in money supply* (M2 and M1–B).—A measure of overall credit availability.

(c) *Change in the S&P 500 Stock Index.*—A measure of investor expectations and firm cost of equity capital.

(d) *Change in new business formation.*

The resulting model explains fairly well the D&B business failure rate (rate per 10,000 firms) and was used to forecast business failures in 1982. Based on fairly optimistic economic forecasts for the 3d and 4th quarter of 1982, the model predicts that the business failure rate for 1982 will be 79 per 10,000 firms (Chart 1 and Table 2). The actual rate for 1982 is running well over 80 per 10,000 as the economy continues to languish in a persistent recession. The 1982 forecast is for the highest failure rate since 1933. We should not underestimate the seriousness of the current situation.

PREDICTING INDIVIDUAL FIRM BANKRUPTCIES

Earlier, I noted that financial distress amongst firms is widespread and even manufacturing entities are suffering from the current economic malaise. I have been assessing manufacturing firm risk profiles for almost a decade and a half now, primarily based on a model developed in 1968 known as the Z-Score approach. This technique combines classical financial ratio analysis with a multivariate statistical procedure in order to enhance the information and predictive content of reported accounting numbers. The statistical approach is known as discriminant analysis and in essence it compares the financial profile of a firm with that of a sample of bank-

rupt firms and a matched sample of non-bankrupt entities. Multivariate analysis implies that a number of financial measures are analyzed simultaneously instead of the traditional one-at-a-time procedure. A number of indicators are objectively weighted so as to achieve maximum classification accuracy on the sample of firms. The resulting Z-Score then becomes the basis for classifying and predicting other manufacturing firms as likely to go bankrupt or not.

The Z-Score model is of the form:

$$Z = 1.2\,X_1 + 1.4\,X_2 + 3.3\,X_3 + 0.6\,X_4 + 1.0\,X_5$$

Z = Overall Credit Score

X_1 = Working Capital/Total Assets

X_2 = Retained Earnings/Total Assets

X_3 = Earnings Before Interest & Taxes/Total Assets

X_4 = Market Value Equity/Total Liabilities

X_5 = Sales/Total Assets

Where $Z < 1.8$ (Danger Zone - High probability of failure classification)

$1.8 > Z < 3.0$ (Grey Area)

> 3.0 (Healthy Zone)

I have analyzed the financial profiles of over 2,000 of the largest publicly traded manufacturing firms in the United States as of March 1982. 3.7 percent (78) of this population had overall risk profile indicating a high probability of failure, i.e., with Z-Scores less than 1.8. Almost 10 percent had scores less than 2.5 which indicates a vulnerable state. This compares with 7 percent of the population as of year-end 1980. In a little over one year, the number of firms "at risk" has increased by about 33 percent.

I have not applied the Z-Score model to small publicly held firms nor to privately held entities. My guess is that the percentage of firms in these smaller firm groupings whose risk profiles indicate financial distress are significantly greater than in the group discussed above. If one could assess a broader cross-section of firms spanning additional sectors, no doubt the number of firms at risk would be far greater than for manufacturers alone—perhaps as high as 15 percent.

A firm's designation as being "at risk" certainly does not mean that it will fail. Even in the worst of years, less than 1 percent of the population of firms actually fail. Over a period of 2-4 years, however, we can observe a significant number of failures. One might extrapolate the current trend and estimate the percentage of failed firms to reach close to 3 percent of the population in the 1980-83 period.

Implications

These are indeed difficult economic times. Unless the economy improves, and interest rates decline significantly, I am afraid that the already staggering number of business failures will swell to levels comparable to the early 1930's. One risk is that these record numbers will themselves cause creditor and debtor behavior which will contribute further to financial distress. If banks ration credit to only the most credit worthy firms, the marginal firm will stand little chance of surviving. It is also probably true that the marginal firm is oftentimes also a small firm.

The real risk, however, is not whether the economy will turn around and stage a recovery, but how long the recovery will last. If the turnaround is relatively short

like the one we experienced in late 1980, then thousands of firms, particularly smaller ones, will not have sufficient time to get back on a positive cash flow basis.

There are both positive and negative factors which make the future recovery period uncertain. One extremely negative factor is that the average U.S. manufacturing firm is now operating at only 70 percent of capacity. Even if the economy does turn around, it will take some time to reach the point whereby new plant and equipment will be built in significant quantity to sustain the inventory type of growth which is likely to start in late 1982. Without real investment, it will be difficult to sustain the growth.

On the positive side, most commercial banks are quite sound despite several years of recession and record loan charge-offs. The banks should provide resiliency to the system and credit should be forthcoming even if the number of very large firm failures continue. Most large loans are spread out amongst many lenders and company risk to any single lender is not great enough to jeopardize the very existence of large banks. I cannot comment upon another major risk area for the banking system: country risk. Here the numbers are so large that an international crisis will gravely impact banks.

The economic outlook for most firms is not encouraging. Firms of all sizes are likely to continue to fail in near record numbers in 1982 with the aggregate failure rate perhaps approaching the level of 1933. At that level, it seems to me that government and private financial institution policies must address the situation directly and provide continuing credit or subsidized programs to enable the productive, but marginal firm, to remain a continuing entity. This should be true for all firms, regardless of size.

98-207 O—82——2

TABLE 1 THE LARGEST U.S. BANKRUPTCIES[a] (IN TERMS OF DOLLAR LIABILITIES) AS OF 1982

		Total Liabilities ($ Millions)	Bankruptcy Petition Date	Filed Under
1.	Penn Central Transportation Co.	3,300	June 1970	Chapter VIII, Section 77
2.	Wickes	2,000	April 1982	Chapter 11
3.	Itel	1,700	January 1981	Chapter 11
4.	Braniff Airlines	1,100	May, 1982	Chapter 11
5.	W.T. Grant Co.	1,000	October 1975	Chapter XI
6.	Seatrain Lines	785	February 1981	Chapter 11
7.	Continental Mortgage Investors	607	March 1976	Chapter XI-X
8.	United Merchants & Manufacturing	552	July 1977	Chapter XI
9.	AM International	510	April 1982	Chapter XI
10.	Saxon Industries	461	April 1982	Chapter 11
11.	Commonwealth Oil Refining Co.	421	March 1978	Chapter XI
12.	W. Judd Kassuba	420	December 1973	Chapter XI
13.	Erie Lackawanna Railroad	404	June 1972	Chapter VIII Section 77
14.	White Motor Corp.	399	September 1980	Chapter 11
15.	Investors Funding Corp.	379	October 1974	Chapter X
16.	Food Fair Corp.	347	October 1978	Chapter XI
17.	Great American Mortgage & Trust	326	March 1977	Chapter XI
18.	McLouth Steel	323	December 1981	Chapter 11
19.	U.S. Financial Services	300	July 1973	Chapter XI
20.	Chase Manhattan Mortgage & Realty Trust	290	February 1979	Chapter XI
21.	Daylin, Inc.	250	February 1975	Chapter XI
22.	Guardian Mortgage Investors	247	March 1978	Chapter XI
23.	Chicago, Rock Island & Pacific	221	March 1975	Chapter VIII, Section 77
24.	Equity Funding Corp. of America	200	April 1973	Chapter X
25.	Interstate Stores, Inc.	190	May 1974	Chapter XI
26.	Fidelity Mortgage Investors	187	January 1975	Chapter XI
27.	Omega, Alpha Corp.	175	September 1974	Chapter X
28.	Lionel Corporation	165	February 1982	Chapter 11
29.	Reading Railroad	158	November 1971	Chapter VIII Section 77
30.	Boston & Maine Railroad	148	December 1975	Chapter VIII, Section 77
31.	Westgate-California	144	February 1974	Chapter X
32.	Colwell Mortgage & Trust	142	February 1978	Chapter XI
33.	Pacific Far East Lines	132	January 1978	Chapter XI
34.	Sambo's Restaurants	130	June 1981	Chapter 11
35.	Allied Supermarkets	124	June 1977	Chapter XI
36.	Penn Dixie Co.	122	April 1980	Chapter 11

a. Does not include commercial banking entities.

TABLE 2
BUSINESS FAILURES AND LIABILITIES[1]
DUN & BRADSTREET TOTALS
ECONOMETRIC FORECAST

Year	Total Business Failures	Failure Rate[2]	Percentage Change	Failure Liabilities	Percentage Change
1970	10,748	44	+17.4%	175,638	+40.8%
1971	10,326	42	- 3.9%	185,641	+ 5.7%
1972	9,566	38	- 7.4%	209,099	+12.6%
1973	9,345	36	- 2.3%	245,972	+17.6%
1974	9,915	38	+ 6.1%	307,931	+25.2%
1975	11,432	43	+15.3%	383,150	+24.4%
1976	9,628	35	-15.8%	312,762	-18.4%
1977	7,919	28	-17.8%	390,872	+25.0%
1978	6,619	24	-16.4%	401,270	+ 2.7%
1979	7,546	28	+14.3%	353,000	-12.0%
1980	11,742	42	+45.0%	394,744	+11.6%
1981	17,041	61	+45.1%	n.a.	n.a.
1982*	22,068	79	+29.5%	—	—

* 1982 Quarterly Failure Rate Forecasts

Q_1	82
Q_2	82
Q_3	80
Q_4	73

[1]Includes Short Term liabilities only
[2]Failure Rate Per 10,000 firms.

CHART 1

Dun's Failure Index → 1920-1982

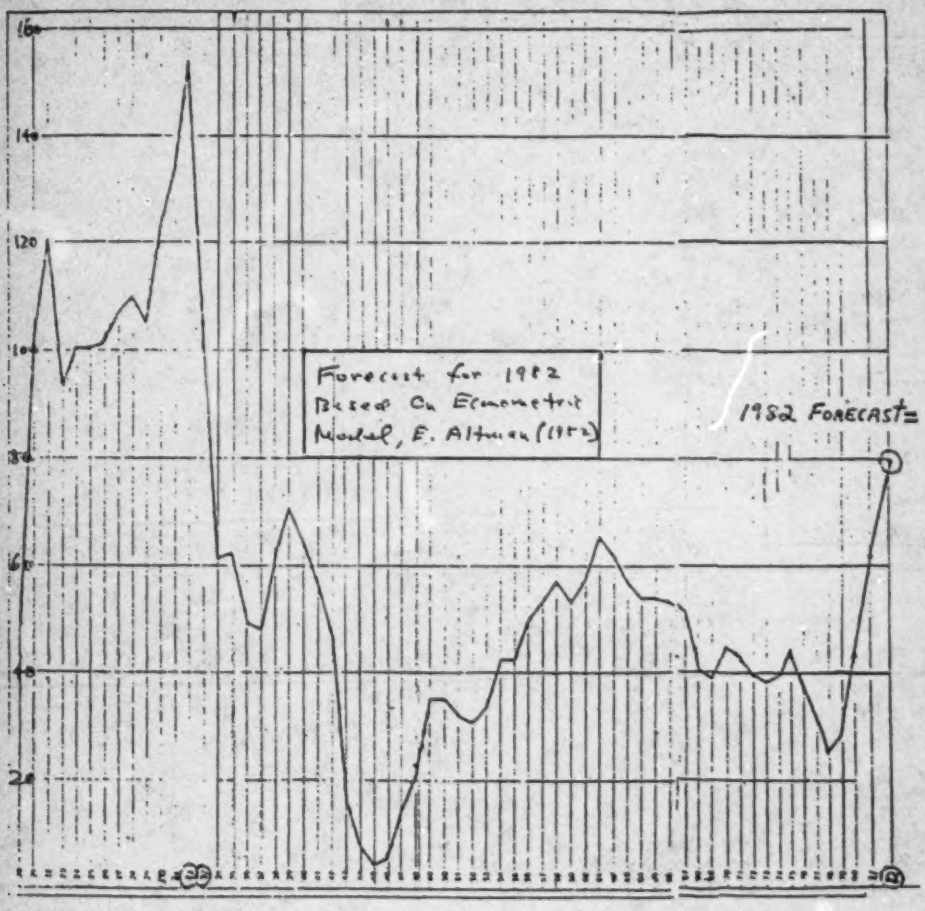
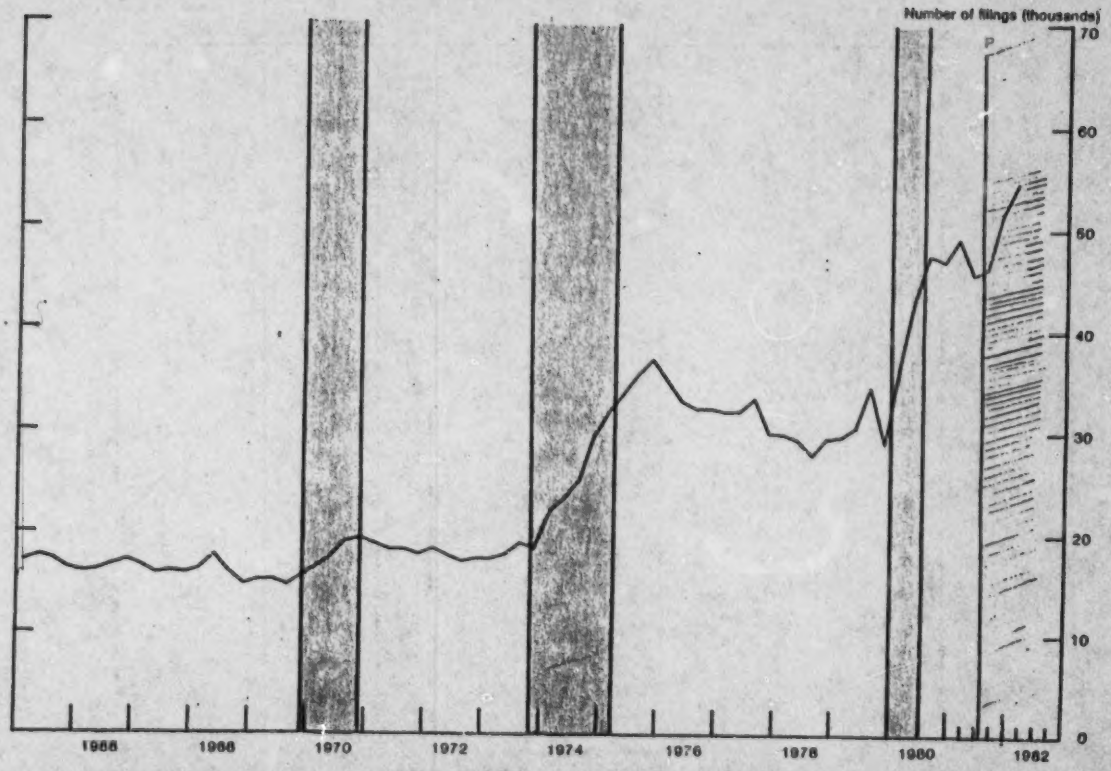


Chart 2

Business Bankruptcies*

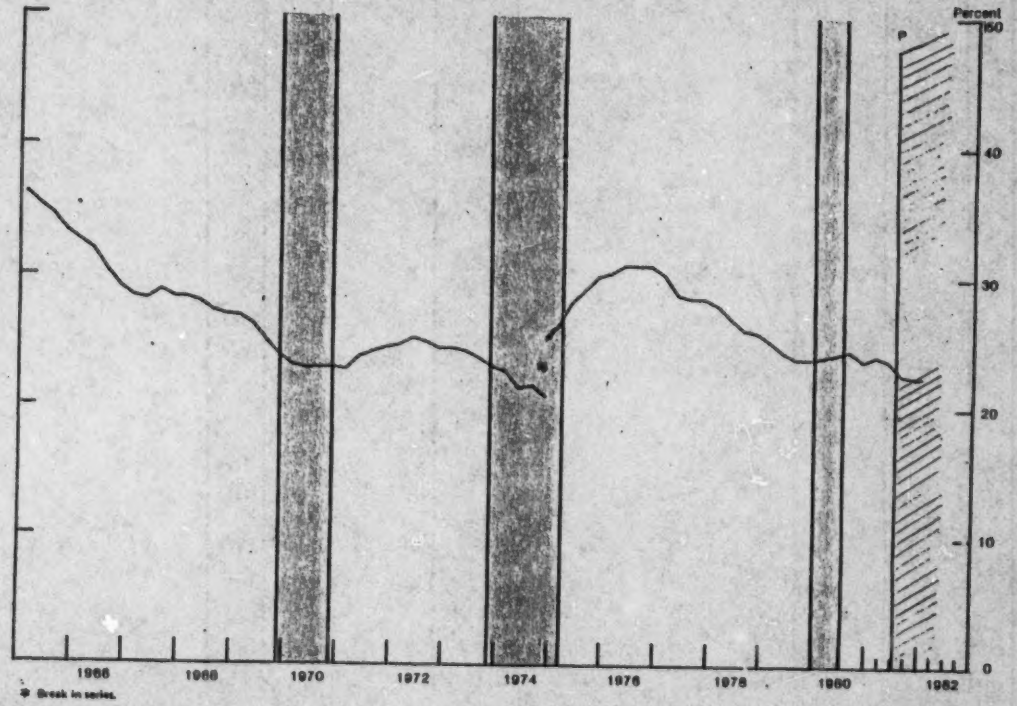


*Nonpersonal filings with U.S. Courts. Quarterly data at annual rates, seasonally adjusted by Federal Reserve.
Latest data are for 1982–Q1

Chart 3

Liquid Assets as a Percent of Current Liabilities

Nonfinancial Corporations



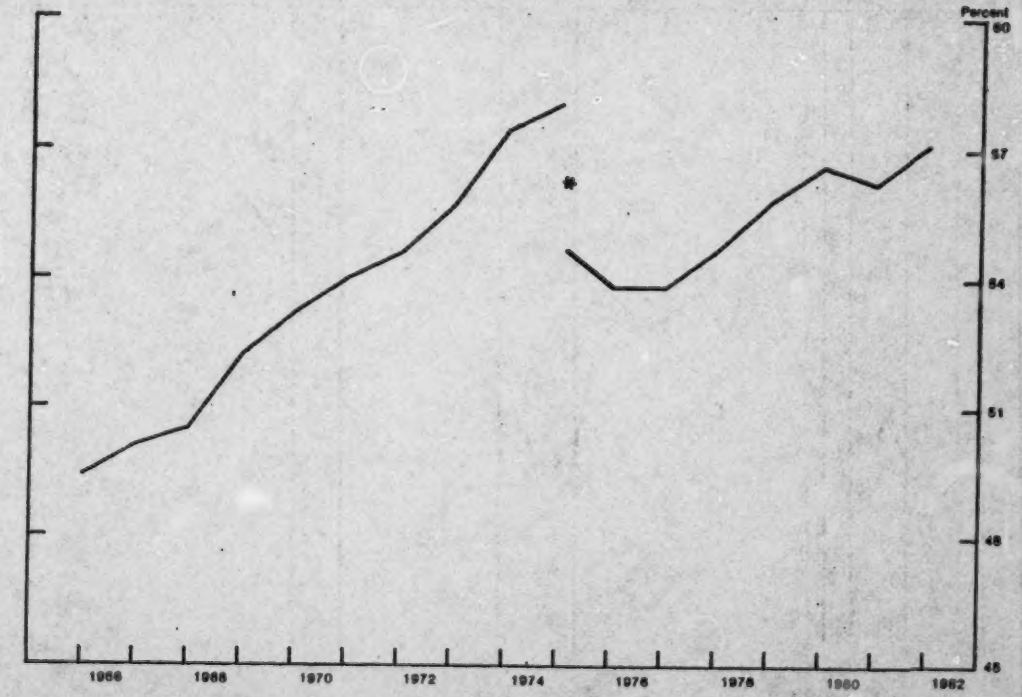
* Break in series.

Flow of Funds, quarterly data for nonfinancial corporations at seasonally adjusted annual rates. Data for 1982–Q1 are preliminary.
Note. Shaded areas denote recessions as defined by NBER.

Chart 1

Ratio of Liabilities to Total Assets

Nonfinancial Corporations



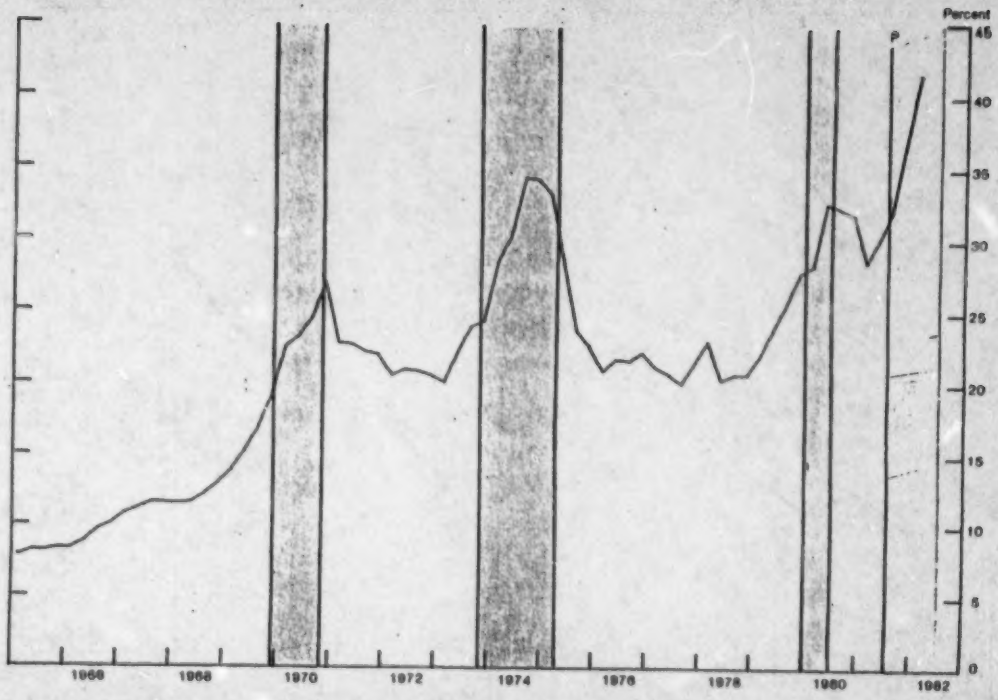
* Break in series.

Flow of Funds, year-end data. Values of assets and liabilities are based on historical costs.

Chart 5

Net Interest Payments as a Percent of Capital Income*

Nonfinancial Corporations



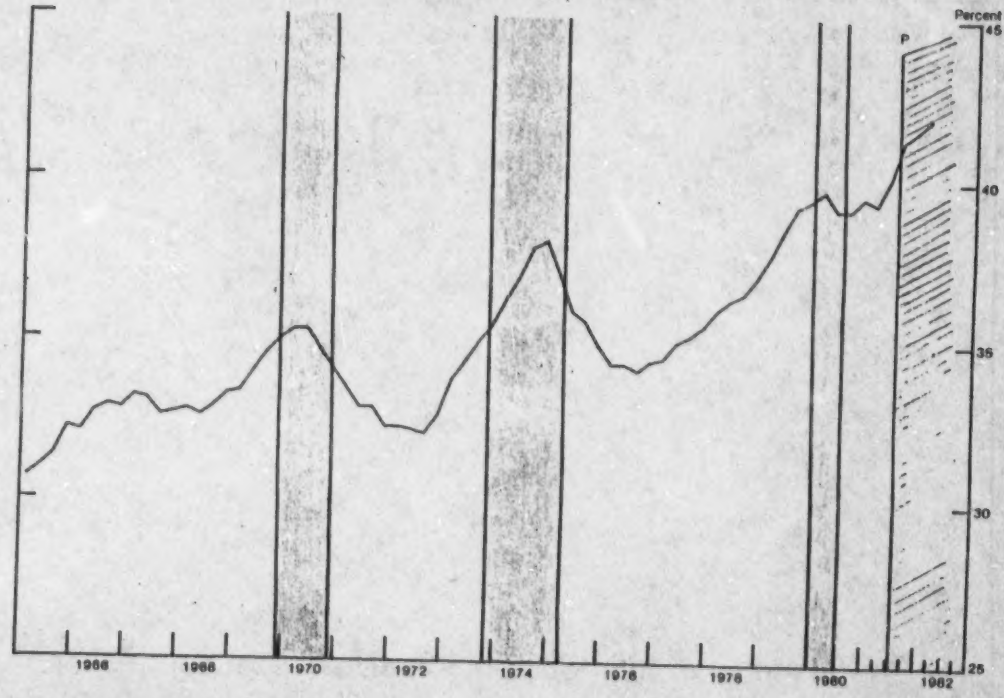
* Capital income is economic profits before tax plus net interest payments.

Department of Commerce, National Income and Product Accounts, quarterly data at seasonally adjusted annual rates.
Data for 1982-Q1 are preliminary and based on estimates of net interest payments by the Federal Reserve Board staff.

Chart 6

Short-term Debt as a Percent of Total Debt

Nonfinancial Corporations



Flow of Funds, quarterly data at seasonally adjusted annual rates.
Data for 1982–Q1 are preliminary.

Note: Shaded areas denote recessions as defined by NBER

Chart 7

FREQUENCY DISTRIBUTION OF FAILURES VS. AGE OF THE FIRM

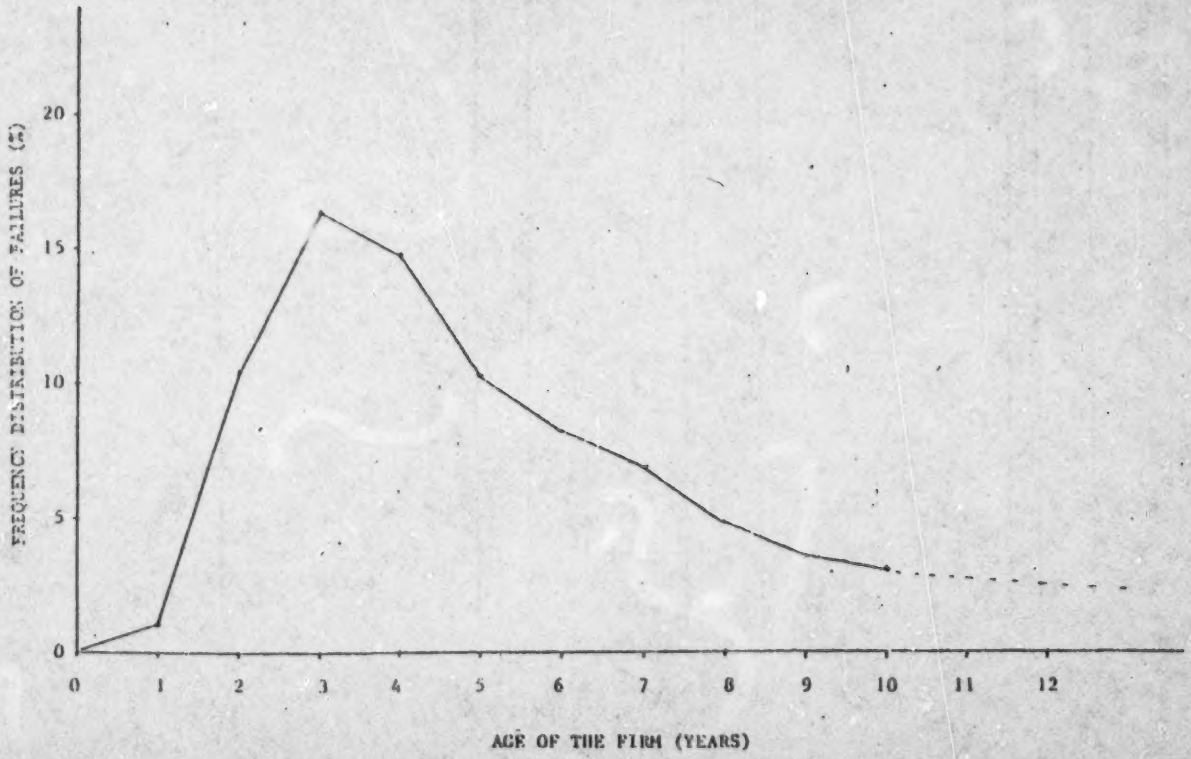
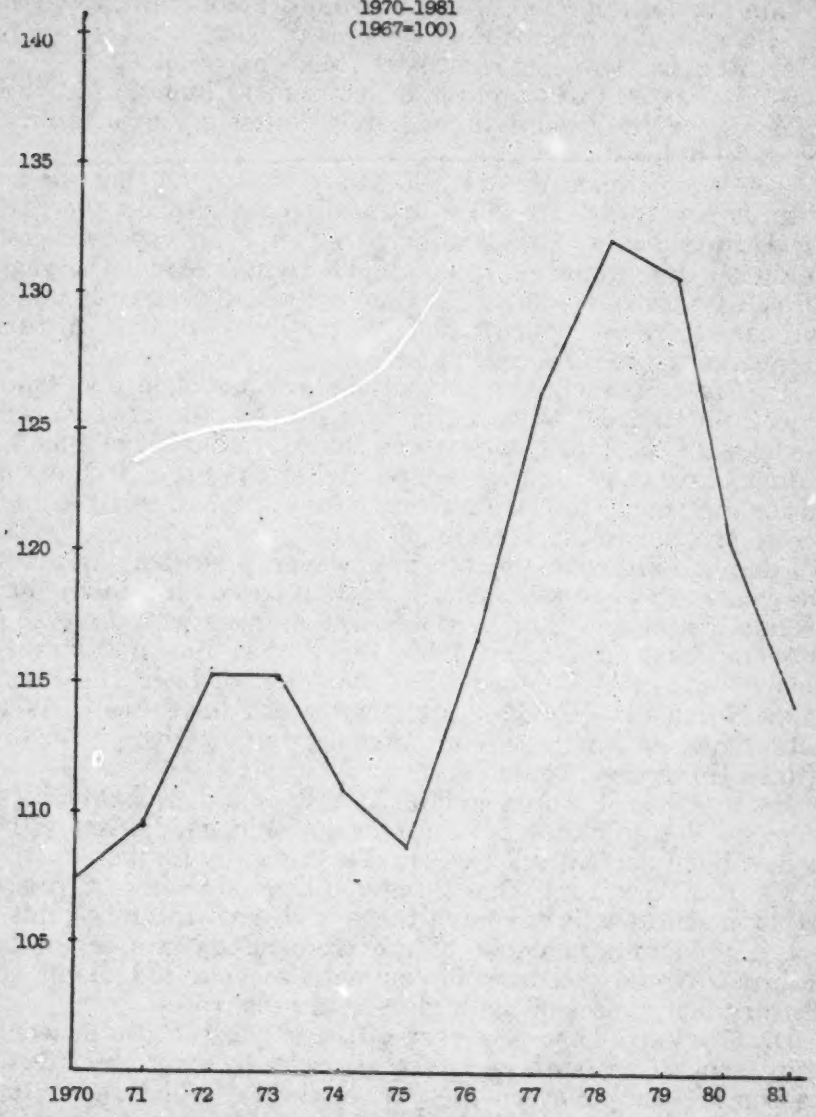


CHART 8

INDEX OF NET BUSINESS FORMATION
1970-1981
(1967=100)



Source: Department of Commerce (Bureau of Economic Analysis), and Dun and Bradstreet, Inc.

Mr. LAFALCE. Thank you very much, Professor Altman, for that fine testimony.

The bells that are ringing right now indicate that there will be 15 minutes for approval of the Journal. I don't think I will go over. Mr. Roemer, if you want to go over——

Mr. ROEMER. I will be right back, Mr. Chairman.

Mr. LAFALCE. I ask unanimous consent to include Mr. Stanton's remarks for the record immediately following my opening statement. So ordered.

Professor Altman, we are well aware of the fact that the business failures per 10,000 are close to the highest level in the history of the United States. They are even higher than you predicted. You predicted they would be 79 per 10,000 companies for the year and I think we now have data that they are about 88 per 10,000. Would you care to revise your predictions for the year 1982 on this point in light of the more recent data?

Dr. ALTMAN. Well, the predictions are based on an econometric model. So, in order to formally revise it, I would have to rerun the model with the latest data which takes quite a bit of time. I think quite clearly that the rate will be higher than the 79 that I predicted for the year. They are already running for the first 6 months at a rate probably close to 88 to 90.

I do not want to go on record, however, predicting an amount for the year, except to say that the 79 was based on a fairly optimistic economic scenario that most of the Congress was predicting as of the end 1981 and early 1982. Since that has not materialized, clearly my rate is under what would have been the rate, if we knew what the economic scenario would have been. As for the actual revised numbers, I am afraid I cannot give you today as to what I think they would be.

My guess is it would not be 100. It would probably be greater than 80. I think that is as far as I would go. Perhaps, that is a hedge, but I don't think I would like to go any further.

Mr. LAFALCE. I see. One thing you have shied away from was an explanation of why we have these high real interest rates, which are a predominant cause of the tremendous number of business failures. Would you care to comment in your judgment what are the primary causes of the high real interest rates?

Dr. ALTMAN. That is a very difficult question to answer in certain terms. I am sure part of the reason is—or a great deal of the reason is—the policy on the part of the Federal Reserve to get inflation under control and, therefore, to keep the money supply from flowing at rates which are considered excessive. Therefore, the banks and the financial institutions have had an unwritten mandate to cut down to a certain extent on their credit.

However, numbers do not seem to bear that out on a consistent basis. Probably, another overall reason for the high interest rates is, at least up to the present time, the expectation that inflation would continue, and not become controlled. We see mixed indicators now in the economy that show in 1 month that inflation is going to come down. The next month, in fact, in today's newspapers, you read that inflation once again is expected to be in double digits.

Until the economy becomes convinced that inflation is under control, those high real interest rates will—those phenomenal interest rates—remain quite high. I do think, however, that the real interest rate is above what it should be. Real interest rates of 10 to 15 percent are very difficult to explain in economic terms. That is taking out inflation and, so, beyond that it would almost seem that we are running into political problems with respect to expenditures and income in the economy and also the great need on the part of the Government to refinance its own debts, which puts continual pressure on the financial markets, which are completely unemotional with respect to business failures.

I am in complete sympathy with the subcommittee in its concern with these interest rates. I don't think that we can expect, however, that interest rates will fall because we want them to fall.

Mr. LAFALCE. Don't you think, Professor, that these high real interest rates are caused primarily because of the concurrent phenomena of the expectation of future excessive deficits and the type of monetary policy that is being promoted by the administration, that these two things are on a collision course?

Dr. ALTMAN. I think that they contribute to them. I certainly think that the high deficits contribute to them. I hesitate to try to quantify that relationship. I do believe that, as I mentioned before your question, the huge Government deficits put a continuous strain on the financial markets—to refinance that debt and to increase it—and, therefore, the final demand for funds causes interest rates to remain quite high. I agree with that.

I also believe that what the Government is doing in terms of trying to fight inflation is quite important. It is very difficult for me to talk against that as an economist. I must admit, however, that this sustained period of high interest rates for several years, without the attendant, or the seemingly inattendant drop in inflation, is difficult for me to justify a continuation of those rates.

Mr. LAFALCE. Well, what remedies would you suggest be taken in order to cope with the tremendous number of small business failures, in order to cope with the unbelievably high real interest rates? We are asking not just for an explanation of the problem, but we are asking for specific prescriptions to cope with the problem.

Dr. ALTMAN. First, let me preface the answer to that by saying that, again, I am on record as being fairly much opposed to large company bailouts. If for no other reason, it is discriminatory against the smaller firms. I do believe that an assessment should be made by financial institutions, perhaps in consultation with the appropriate Government agencies, who subsidize those firms, which are temporarily suffering from these high interest rates, but which are and appear to be a productive, marginal firm in the economy.

Mr. LAFALCE. Now, who should do this? Did you say the private financial institutions or did you say Government or——

Dr. ALTMAN. I think it has to be the private financial institutions with the assistance of Government in terms of some subsidized loan programs.

Mr. LAFALCE. Well, then you are saying both?

Dr. ALTMAN. Yes, that is what I said.

Mr. LAFALCE. How would both the private and the public sector go about determining which firms are the best firms, the most productive firms? Second, what form would that subsidy take? Third, is that dealing with the firms or is that dealing with the underlying cause of the problem or is that just dealing with the symptoms of the problem?

Dr. ALTMAN. No, I think it is dealing with the firm and then the underlying causes. If the underlying causes are that the firm is ineffective, that its management has been remiss in extending itself too much, if it is not——

Mr. LAFALCE. No, no, no. You are missing my point. Let's assume that we are not going to assist firms that are failing primarily because of managerial or other related difficulties, but only those that are having difficulty because of the excessively high real interest rates. Do we subsidize the loans given to them or do we try to bring down the interest rates? I thought you were initially suggesting that we do all that is possible to bring down those high real interest rates. Now, you seem to me to be talking about a subsidy of the interest rate to bring it down to some manageable level for the firm.

Dr. ALTMAN. I think the latter is what I was referring to. That is right. Your interpretation is correct. I have not done enough analysis or work to figure out how we can bring down those interest rates in an effective way. I do think we need to assess the creditworthiness of firms and if they are temporarily insolvent, perhaps due to these high interest rates, that programs be initiated between the Government and the private sector to subsidize those firms. I think what you need to do then is have much more of a selective system.

I think a general bailout policy for large and small firms would be a serious mistake for the economy. The only way to justify it is to have some mechanism set up to assess the creditworthiness of these companies as to their overall viability.

Mr. LAFALCE. What percentage of those firms that have experienced failure in the past years do you think the primary reason was high real interest rates and are you suggesting that we come up with a program for subsidizing all of those, a twofold question?

Dr. ALTMAN. I see. It is two questions.

Certainly, if the cause is the high real interest rates and that they are fundamentally a solvent firm, I will say those are the firms to concentrate on. I really don't know the percentage of those firms. You can't disassociate easily the impact of high real interest rates and managerial ineffectiveness. Dun & Bradstreet figures show that over 90 percent of all firms fail because of managerial incompetence. I think those figures are very difficult to assess as to their correctness.

If I had to take a guess, and it would simply be a guess at this point, it would be that probably a small percentage of those firms would be subsidizable—perhaps 20 percent. But that is a guess. You know, it is a very difficult thing to disassociate managerial problems and high interest rates and say that the firm would have continued very comfortably if it wasn't for the high interest rates because we are assuming that management itself would be able to perpetuate itself. We normally observe something in the vicinity of

40 to 50 per 10,000 firms failing, even in low interest rate periods. So, it is difficult to say what percent; perhaps 20 percent would be a ballpark figure.

Mr. LAFALCE. Congressman Roemer.

Mr. ROEMER. Yes. Thank you, Mr. Chairman.

Just a followup on that point. Isn't the wearing effect exponential, though? I mean, the longer we sit with the high interest rate, even your 20-percent figure is apt to expand exponentially?

Dr. ALTMAN. Absolutely.

Mr. ROEMER. You gave very interesting testimony and let me just pick up on a couple parts. I apologize for being gone the last few minutes. I don't want to cover ground that has already been covered.

Several things were interesting to me as I prepared myself to read in detail your testimony. First, you talked about the banks in this country, and how they have in effect not called the loans or not sat rigidly on all the notes in these tough times. I think, if I am not putting words in your mouth; that is what you said. I wonder what increase in the failure rate would we see if banks were in their own best business interests—you said they weren't philanthropic organizations, and I agree—if they were to call the loans due, if they were to be as rigid in their analysis of the business community as in times past they have been. Have you got a feel for that? What are the marginal potential disasters out there, small and large, in regard to the banks tightening screws?

Dr. ALTMAN. Well, I think your question really says two different things. My point was that they are not philanthropic; if they felt that they would do better by forcing the firms to fail, they would have done so. So, the fact that they haven't done so means that they feel that the firm is worth more alive than dead. I think they have been fairly rigid in their analysis.

Mr. ROEMER. Well, let me ask it another way. Having sat on a bank board for a number of years myself before I came to the Congress, it doesn't make me an expert, but I am privy to the kind of negotiations and discussions that go on in those sorts of meetings.

Right now, we have firms in this country who really don't care what the interest rates are. They are borrowing money regardless of the cost of that money to stay alive. Now, as their liquidity diminishes and their ability to repay those loans diminishes in a corresponding manner, at some point the call will be given. Now, there is great economic discussion about the domino effect and that sort of thing. Have you given any thought to that? How close are we to that sort of thing? Is there a way to quantify that? What are the proportions of that impending disaster?

Dr. ALTMAN. Our analysis shows that the bankrupt profile of all companies is probably in the 10- to 15-percent range.

Mr. ROEMER. Regardless of their size?

Dr. ALTMAN. Regardless of their size.

Mr. ROEMER. Or their age?

Dr. ALTMAN. I am sorry. That is for all firms. It would be for large and small firms——

Mr. ROEMER. Is that your Z-Score approach?

Dr. ALTMAN. That is right. That is looking at the largest firms. If you increased it to all sectors of the economy and all sizes, that

number would be at least 15 percent and probably higher. That implies to me that firms which have failure profiles—in other words, profiles similar to firms which have failed in the past—are upward of 15 percent of the population. It is a tremendous number of firms. So, the potential is there if the current malaise does continue, for that many to fail. I am not talking about an increase of 15 percent. I am talking about 10 to 15 percent of the population. With a population close to 10 million firms, you can see what those numbers look like.

Mr. ROEMER. On a comparable index to your 90 per 10,000 firms, that would be 1,500?

Dr. ALTMAN. That is a good question. That Dun & Bradstreet failure rate per 10,000—I think, perhaps, the gentleman from Dun & Bradstreet can tell us better—is based on a population of probably close to 3 million firms that they list. So, we are talking about 300,000 of those firms being at risk or more. The potential is huge. We are only observing in the economy failures in the range of one-half to 1 percent of firms, but the potential for firms, in a sustained period of economic problems, to fail is enormous.

Mr. ROEMER. You would agree with my intuitive judgment, I hope, that the longer we continue with this combination of a lethargic economy and high real interest rates, the chance of that sort of domino effect increases.

Dr. ALTMAN. Absolutely. Well, I wouldn't even call it domino in this case, Mr. Roemer. I think your first statement is absolutely correct that—and I tried to emphasize this in my comments—that the risk in this economy is not that we will come out of this recession. There is no doubt that we will come out—well, maybe we are out of it now. The risk is that those high interest rates will blunt this recovery and we will fall back into a recession in 1983. That is the real risk, not only for the small firms, but for all firms. This is a very critical period that is coming up within the next 6 months. We cannot feel comfortable that the indicators now say that perhaps even in the second quarter we are coming out of the recession with a real growth of something like one-half of 1 percent. That is of no comfort to me. I want to see that growth continue through 1983 at an expanding rate. If it is blunted, the economy in general is in real trouble.

Mr. ROEMER. Before I yield to my good friend from the Dakotas, let me ask if you would agree that your analysis is that we are going to come out of the recession, but the critical factor is how sustained the recovery will be—that the single greatest impediment to a sustained recovery are real interest rates?

Dr. ALTMAN. I would say that is an extremely important factor.

Mr. ROEMER. What is more important? You hesitated in answering.

Dr. ALTMAN. I hesitated because I haven't analyzed all of this carefully. We need a sustained economic period of growth and the high interest rates have a risk of blunting that in the near future. The next point is extremely important: I am worried about the capacity rate, where, at 70-percent capacity, high interest rates will blunt any significant increase in the investment in real plant and equipment. We will invest in inventory surely, and if interest rates stay high it is going to blunt that real investment. I hesitate to say

it is the most important case. I know that is what a lot of people are saying. All I can say is interest rates are extremely important.

Mr. ROEMER. Well, commonsense tells one that capital and investment are critical to growth, and if the cost of that capital and investment is prohibitive, then real interest rates might be the single most important impediment to sustained recovery.

Dr. ALTMAN. Well, the cost is high. What is more important is: Are the returns going to be higher?

Mr. LAFALCE. Let me ask the question in a slightly different way, Professor, if I may.

Dr. ALTMAN. Yes.

Mr. LAFALCE. What do you think the small businessman would answer if we were to ask 100 small businessmen what they think was the primary cause of their difficulties right now, and we listed as one of the items to check high interest rates? How many of the 100 do you think would check high interest rates?

Dr. ALTMAN. I think you know the answer to that.

Mr. LAFALCE. Would you answer it rather than suggest that I know the answer? You seem to have some aversion——

Dr. ALTMAN. I would say probably 100 percent.

Mr. LAFALCE. Well, Mr. Roemer disagrees. He thinks 106 out of 100. I tend to agree with him.

Mr. ROEMER. I think what we are getting at, and I will yield, is a question that I haven't asked well, but one that is on my mind. Do you foresee an economic society in the next decade or two, where interest rates will not come down and where the economy of this society will have to adjust to these real interest rates at these extraordinarily high levels? Can we adjust?

Dr. ALTMAN. I am sorry. I can't answer that.

Mr. ROEMER. I yield.

Mr. DORGAN. Thank you very much.

First, Mr. Chairman, let me commend you for holding these hearings. I think they are very timely and very important.

Mr. LAFALCE. Delighted that you are sitting with us.

Mr. DORGAN. I arrived late but did have a chance to peruse your statement. I would just like to ask a couple of questions. You said there is no doubt we will have a recovery. I hope that is true, but I wonder if we are not all suggesting there will be a recovery because we say there will be a recovery. I am wondering if there is not the possibility of a Thatcherism-type approach here in this country, where we languish for a good long while at the trough of a recession.

Dr. ALTMAN. That is the risk.

Mr. DORGAN. Well, and we all say there is going to be a recovery because we all believe there is going to be inventory replenishment at some point, but we have experienced in the last 3 years, from early 1979 to early 1982, virtually no growth. We have had a couple of peaks. They have been washed out by the valleys. Our economy is virtually in exactly the same position today as it was 3 years ago, which is devastating because we are competing with some tough international competitors.

So, we don't want to create only a continuous spurt, sputter economy. But even more important than that I worry that we are talking about a recovery that will happen simply because we say it will

happen. What is the basis at this point for believing with 15- or 16- or 17-percent interest rates there will be a recovery, except for minor inventory replenishment?

Dr. ALTMAN. I don't see that there is much of a basis either.

Mr. DORGAN. You see, that is my concern. You are concerned about whether we go into a short recovery and then back into a recession. I am concerned that there may not even be a short recovery unless there is a softening of monetary policy. Now, Paul Voelker came to the Fed in 1979. We have not been the same since. I mean, this economy of ours has been intoxicated and acting in a very unusual way since Paul Voelker assumed the reins of the Fed and decided we are going to do something different with monetary policy. Unfortunately, that something different is virtually strangling small business. The economic dislocations that are being caused by the monetary policy, that is concerned only with its numerical results, is devastating to small business.

I am not an economist. I have taught economics, but I am not somebody who considers myself a professional economist. What I see in this town is very interesting. I see people who think that we have a board up here of about 15 spigots and all we do is adjust the right spigot in the right way, investment credit, M-1B, depreciation. We just keep adjusting these handles until we get the right flow and then the engine starts running the right way again. I think that is fundamentally foolish and that is our problem.

If you merely turn on the spigot of the credit available out there, you are not addressing the fact that it might be going to the wrong force; that Mobil might be getting $5.5 billion to buy Marathon rather than a small business or a series of small businesses in getting it to build something and create new wealth and jobs. So, I sense that we are sort of fouled up in this town with respect to all of that manipulation, but let me get to a question.

In our country's history there is some evidence that whenever we have this continual battle between the financiers and the producers—there is always a continual struggle to see who is prevailing at the moment—whenever the financiers in our history in this country have become dominant and been the signal callers, that we have a significant slowdown in economic growth. Do you have any analysis of that or any historical perspective on that? I sense that is what is happening today.

Dr. ALTMAN. You know, I agree with just about everything you said, but the last point. I don't disagree, perhaps, but I don't think we have any evidence to put the blame on financiers. Let me try to maybe rephrase your point and that is we have to get back to the basics, not only in motivating, but helping the productive part of the economy, in manufacturing—but I emphasize now this is a different recession than we have had before. It is hitting all sectors and it isn't only the real estate investment trusts or the railroaders. It isn't only the retailers, which always operate on tight, thin margins. It is a broad cross-section of firms and I think we do need to do something to stimulate the economy.

The only reason I hesitate to say what is No. 1 in importance, whether it is interest rates, and that is what we have to get down, is because I don't know if that is the only thing. I do know it is extremely important. Frankly, I don't know how to reduce rates, to

mandate that interest rates go down, if that is what you are looking for. But if high interest rates are potentially the blunting to this recovery, and I think they are an important factor, unless they are reduced, this country is in a great deal of trouble.

Mr. DORGAN. If I may take just another minute.

Dr. ALTMAN. Surely.

Mr. DORGAN. Why are interest rates high, in your opinion?

Dr. ALTMAN. This question was asked before, and it goes back to the supply and demand of money. There is so much demand for money coming from not only the private sector, but the public sector in terms of financial deficits, that this is an extremely important reason why we have the high interest rates. And, also, a built-in inflation expectation. Those two factors are probably the most important ones.

Mr. DORGAN. With the presence of the Federal Reserve Board involving themselves artificially in the supply side, do you really have the operation of the supply and demand curve that establishes a market interest rate?

Dr. ALTMAN. Surely. You have a supply and demand curve. I am not convinced that the Federal Reserve Board, despite their professed interest in fighting inflation by reducing the supply of money, is all that successful at times. After all, financial institutions can make loans regardless of what the Federal Reserve is doing.

Mr. DORGAN. Just one more question and I appreciate the gentleman for yielding, but there are some who say the interest rates are high because of the uncertainty of the future with respect to inflation. Some people say that banks have to charge just because of the uncertain future, which doesn't explain the short-term interest rates because you can certainly see that we are not going to have 18-percent inflation in the next 12 months.

Dr. ALTMAN. That is right.

Mr. DORGAN. But you are saying it is not because of the uncertainty of the future. You are saying it is because of the normal action of the supply and demand relationship?

Dr. ALTMAN. Yes, the supply and demand is what is causing the short-term interest rates to be so high. You have the tremendous demand for money in the short run.

Mr. DORGAN. And the restricted supply.

Dr. ALTMAN. Well, certainly, the supply is not as great as if the interest rates——

Mr. DORGAN. One would normally think that when you enter a deep recession as we have had in this country, that the demand for money abates. I have owned a couple of small businesses and I know that you do less borrowing, No. 1, when interest rates are high and, No. 2, when you have a deep recession and conventional wisdom would say that the demand for money decreases.

Dr. ALTMAN. Yes, but it hasn't in the short run. That is the problem. The short-run demand has been increasing. It is at the highest level it has ever been.

Mr. DORGAN. But that is because they are using short-run, short-term money for long-term capital.

Dr. ALTMAN. Yes. It is a big mistake. I agree.

Mr. DORGAN. But when it comes to an aggregate demand for money, that is simply an exchange. That wouldn't effect the aggregate demand.

Dr. ALTMAN. No. That explains the yield curve, the way it looks with the very high short-term rate. That is right. That is correct, Mr. Dorgan.

Mr. DORGAN. But logic would say that in a deep recession you would have an overall aggregate decrease in demand.

Dr. ALTMAN. Yes, and that is why interest rates do come down in recessions.

Mr. DORGAN. Exactly, and so that doesn't explain why interest rates remain high today.

Dr. ALTMAN. No. It means that there are other demands there. It is not only the business demands. There are Government demands and the drying up of equity markets. Firms can't go anywhere else for financing.

Mr. DORGAN. I think there might be some institutional influences here. I think the market gets used to 15-percent interest rates or 16-percent interest rates. There might be another influence.

Mr. Chairman, thanks for yielding.

Mr. LAFALCE. I appreciate your questions. They were excellent, but let me go back to a point that I wanted to explore.

Professor, in your testimony you implied that small businesses had assumed a great indebtedness in the past because of the expectation of inflation and in a certain sense inflation would pay off that indebtedness. What you were saying is that small businesses and businesses and individuals had become accustomed to inflation and knew how to deal with it. One way to deal with it was through indebtedness. I don't like the way in which many chose to deal with inflation, but you could, assuming there would be continuous inflation and the interest rates would remain at that level, operate that way. Is there some way you think these small businesses can deal in the future successfully with high interest rates? Let's say we knew that interest rates would be at roughly 16 percent for the next 5 years. Is there some way that businesses could adapt to that or what that by cataclysmic in nature?

Dr. ALTMAN. It would be very difficult to adapt in a competitive environment.

Mr. LAFALCE. For whom? All business or just small business?

Dr. ALTMAN. All business in general and in particular, small business. Small businesses generally do not have the ability to pass along price increases, their cost increases in the form of prices. They generally compete in more competitive markets and have more competition.

I think what you are asking me is, can they adapt to the high interest rates, and I think the sustaining of those high interest rates will be, to use your word, cataclysmic, yes. It is very difficult for them to pass along this when their interest expenses are over 40 cents for every dollar earned on average. It is probably higher with the small businesses.

Mr. ROEMER. Will the chairman yield on that point?

Mr. LAFALCE. Surely.

Mr. ROEMER. You are a predictor of some note, as evidenced by your testimony. You had a large article some years back about failure rate. You are willing to admit that you were probably underestimating the problem just a couple of months back. I appreciate that. Let's predict the future. Let's predict a year from now. If interest rates are a year from today as high as they are today, what will this economy look like in terms of the failure rate of businesses? Won't it be higher than even you think in your current analysis?

Dr. ALTMAN. If the economy does not turn around, I would agree with that.

Mr. ROEMER. All right. Let's take (a) if interest rates are as high as they are today, but the economy is in the midst of a recovery—that gets to the chairman's question—can business live with these interest rates if there is a recovery, and (b) can there be a recovery at these interest rates in your opinion?

Dr. ALTMAN. Those are difficult questions. There will be very few of these marginal firms that will be able to continue to exist if interest rates do not fall.

Mr. ROEMER. Regardless of general recovery?

Dr. ALTMAN. Well, we have to look at their returns and if their returns do increase sufficiently to cover interest costs, then there will not be a problem. The problem is, as you put it in that circular scenario, if interest rates remain high, will there be the significant recovery. But if you say "yes," there will be a significant recovery and a sustainable one, then I think that they will be able to survive.

Mr. ROEMER. I am a cattle farmer by trade and I am trying to put you in the corral and you don't want to get in there, but we asked you earlier and I am going to ask you again. Aren't high interest rates the key to this economy, not the only key, but aren't they a key to (a) having a sustained recovery, and (b) alleviating the problem of this extraordinarily high failure rate?

Dr. ALTMAN. They are one of the keys.

Mr. ROEMER. Can business accommodate itself between 15- and 20-percent interest rates without an extraordinary readjustment in how we do business in this country and probably losing a lot of firms in the process?

Dr. ALTMAN. Yes, the latter is certainly true. The former, I say that these firms can continue if they are able to pass along these interest rates. They have not shown lately the ability to do that.

Mr. ROEMER. Do you think that high interest rates have any effect on inflation? Are they connected in any manner?

Dr. ALTMAN. Yes.

Mr. ROEMER. The higher in one area, the spilloff in the other. For example, high interest rates probably increase the chance of higher inflation?

Dr. ALTMAN. It doesn't help it. I would not say that it fits into the basket of goods that they use to calculate the inflation rate.

Mr. ROEMER. What about this talk at the White House as one occasionally drifts through there about every 3 months that this is good for the economy? The economy somehow needed to be cleansed after years of fiscal mismanagement, bad tax policy, unrealistic expectations, inflation running rampant for a decade and a

half, that this was inevitable. It is bad. It is unfortunate. It is tough, but it will make America a better place in which to live. Do you agree with that?

Dr. ALTMAN. I believed it. I believed it in 1980 when I did that original forecast that you referred to. I still believe that, in general, wholesale bailouts are not the answer to our economy. It breeds complacency, but I fear that the rate that we are now experiencing is no longer a tolerable one. This 80 to 90 per 10,000 is a lot different than it was in 1980 when I came through with the forecast, when it was 40 per 10,000 and going up to 50. I am concerned that this high rate is no longer wholly cleansing us of those firms that are not productive. What I am advocating is that we now work hard with those firms which are productive and try to keep them as productive parts of the economy. There are clearly some firms that will fail and probably shouldn't because of this sustained period of high interest rates and economic malaise.

Mr. LAFALCE. I am afraid that we will have to conclude your testimony, Professor. I want to thank you very much for your predictions, for your insights.

PANEL CONSISTING OF JOSEPH W. DUNCAN; AND HERBERT LIEBENSON

I would now like to call upon our next two witnesses to come to the table at the same time; both Mr. Joseph Duncan, the chief statistician for the Dun & Bradstreet Corp. and also Herbert Liebenson, on behalf of the National Small Business Association.

I will introduce the entire text of your testimony in the record at this time, if there is no objection. So ordered. We ask each of you to summarize your testimony if you so desire.

Mr. Duncan, please proceed.

TESTIMONY OF JOSEPH W. DUNCAN, CHIEF STATISTICIAN, DUN & BRADSTREET CORP.

Mr. DUNCAN. Thank you, Mr. Chairman.

I am certainly pleased to have this opportunity to discuss with you the Dun & Bradstreet data concerning business failures. These data have already been discussed this morning. First I would like to commend the committee for the sound manner by which it approached the subject of business failures. It is important to look at the numbers we are talking about and where do they come from, because too frequently we quote statistics without understanding the source or what the data mean.

As Dr. Altman and your questioning have already indicated, high interest rates have created heavy pressures on most businesses. All businesses require both short-term capital to finance inventory and other working capital requirements and long-term debt to finance plant and equipment improvement, as well as expansion. The payment of high interest costs makes it difficult for many businesses, both large and small, to operate profitably.

What I would like to informally comment on—since my full text will be in the record—is the nature of our data about business failure. I will also discuss some of the studies we have made concerning the causes of business failure.

First, our statistics are statistics that are pragmatically defined. We define business failures as situations where liabilities of the firm were not met. Now, an economist, which is another hat that I wear, could define business failure as a situation where someone decided that the return on their investment was not sufficient. While these businesses paid their bills, they closed down because they failed to make a high rate of return.

Likewise, on a purist basis, an economist could say that a business failure occurs any time that you do not make a rate of return that is equal to the opportunity costs of putting the money in the bank or other investment situation.

So, the first point I would make is that our business failure statistics focus specifically only on those cases where a business stops and liabilities are not paid.

Mr. ROEMER. It takes both of those to meet your definition?

Mr. DUNCAN. That is right. In other words, somebody has lost money. There is a secondary effect on the business failure.

The data collected by our company are collected as a result of our regular analysis of company credit. We have reporters in cities throughout the Nation who daily review court actions—people filing bankruptcy and not meeting their debt obligations. Data on noncourt actions are also obtained from a variety of sources, such as scanning the auction and foreclosure notices, contact with the local boards of trade and credit managers associations, as well as from the reporter's round of regular interviews in the process of preparing business information reports on millions of individual businesses.

As I think you know, we have an active file on nearly 5 million businesses in the United States.

The reason I mention this data collection procedure is that this data has been collected now for over 100 years using similar techniques. It is not a byproduct of current concern about business failure. It is a activity that our corporation has followed over a long period of time as we analyze the credit of individual corporations.

However, there are some limitations to this data, which I think you should take into account. The first point I would make is the rate per 10,000 is not a rate for all corporations that one might know about. There is a question as to what is a viable business corporation. My formal testimony has tables comparing proprietorships, partnerships and corporations with our total population count. Obviously, if you include as a business a number of partnerships and proprietorships, the population of businesses would be much larger that we used as our base number.

We include basically those types of firms that are included in our directory and our business inventory of five million businesses that I spoke about. The inventory of five million is a larger number than our base because many companies have branches.

I might note that there is an alternative source of data and that is the data from the U.S. bankruptcy court, those people that file bankruptcies. There have been studies comparing our data with the court data. There are some differences in terms of coverage, as I just talked about, as well as differences in definitions, but the significant thing is that the court data counts case numbers, not business numbers. Also the courts have shifted their concept of meas-

urement over time. For example, it used to be husband and wife business that there were two cases. That has now been corrected, but if you look at the historic trend the court numbers are distorted.

So, I would just simply say that while Dun & Bradstreet data has some limitations, some problems of coverage and definition of how many businesses exist in the Nation, the important point to note is that there is a consistent pattern over a long period of time. Thus when we see things like the chart that is behind you, it is quite clear that there are enormous changes in the rate of business failures. Therefore, I suggest that you should have some confidence in these trends.

My formal testimony includes data that will be released later this week, covering the first 22 weeks of this year. It is very clear that the number of business failures has increased sharply. The total number increased 45 percent in 1980 from 1979 and 55 percent in 1981; a 2-year increase of 128 percent. This is the sharpest increase since 1947 to 1949, when the restructuring of the economy following the postwar period was reflected in a high rate of business failure.

In our preliminary data for the first 22 weeks of 1982 the number of reported business failures is up 44.3 percent over 1 year ago. The trend is consistent with an estimate of 85 to 90 failures per 10,000, which has already been presented today.

I would note one thing that I have observed in the data over the last several weeks and that is, that if you look at the aggregate change for the year, as compared with 1 year ago, there has been some moderation. In other words, we are not in a situation where the percentage change over 1 year ago is increasing each week. The increase over 1 year ago has dropped about 4 percentage points in the last 3 or 4 weeks. That does not diminish the critical nature of business failures; we are still experiencing 45 percent higher levels than 1 year ago. We are not in an accelerating condition. We are in a serious condition.

I will also comment on the causes of business failure. We complete a report on each failure we note. We try to find out from the creditors what they think was the cause of each business failure. As was noted earlier, 9 out of 10 causes are classified as some form of management or mismanagement problem. That may sound unfair, but realistically the details—particularly for small businesses—indicate that many business people have entered a new line of business for which they have no previous experience or they enter a situation even though they have had no previous management experience.

Thus it is not unrealistic to observe that many business failures represent management failure. I should note that one of the management failures that is serious today is an inability to deal with the capital situation; that is, a failure to recognize the impact of high interest rates on their basic pattern of doing business. Therefore, high interest rates become an underlying factor, a problem which the manager has to deal with.

Let me turn this around. We have talked a lot about high interest cost already this morning, but if you look at the economy, you will find for many of these firms that they are faced with two other

things. The first is sagging sales. If a manager that doesn't cut back his operating expenses in the face of sagging sales, profit margins shrink.

The second problem with many of the businesses, both large and small, is a failure to recognize that this is a deflationary economy. Following a long history of living with higher and higher rates of inflation and being able to pass on higher costs to their customers they cannot do so today. For example, if you look throughout the society, you find labor unions cutting back on their demands, you find home prices being lower, and you find other forms of cutting back on list prices. Even in the auto industry, when they say we will give you a 12.8-percent auto loan, what they are really doing is cutting the price of the car. So, this is deflationary economy. We have many problems because managers have failed to take into account that they are operating under a new set of economic rules.

Therefore, I believe you have to look at all of these factors and not just the simple, obvious point that everybody sees, which is high interest cost.

To conclude, it is clear that we are in a period of high credit costs and growing demands on credit markets. Those growing demands include, obviously, the demand of Government to finance a large deficit. One of our subsidiary companies is Moody's. We receive from corporations and municipalities their calendar of plans to come to the financial market. Those statistics project for this year that they expect to come to the market for 40 percent more financing than 1 year ago estimates.

In other words, the demands for capital are pervasive underlining the pressure on interest rates. It is clear to almost all economists that with high interest rates, the recovery will be blunted. If the recovery is blunted, the pressures on small business and large business to increase sales, and to pay their interest costs, are going to be severe.

Therefore, I share the view that we face more business failures in the weeks and months ahead until our economy recovers.

Thank you, Mr. Chairman.

[Mr. Duncan's prepared statement with attachments follow:]

PREPARED STATEMENT OF JOSEPH W. DUNCAN, CHIEF STATISTICIAN, DUN & BRADSTREET CORP.

DUN & BRADSTREET DATA ON BUSINESS FAILURES

I am honored to have this opportunity to discuss with you the Dun & Bradstreet Corporation data concerning business failures. High interest rates have created heavy pressures on most businesses since they require both short-term capital to finance inventory and other working capital requirements and long-term debt to finance plant and equipment improvement and expansion. The payment of high interest costs makes it difficult for many businesses, both large and small, to operate profitably.

Before discussing current trends in our statistics I would first like to discuss the source of our information. Then, after summarizing current data I would like to comment on some of our studies about the causes of business failure.

BACKGROUND

Business failure data have been published by Dun & Bradstreet since 1857. These statistics are widely reported in government publications such as the Statistical Abstract, the Survey of Current Business and the Economic Report of the President.

Dun & Bradstreet uses a pragmatic definition of business failure in collecting our statistics. Our definition is:

"Business failures include those businesses that ceased operations following assignment for bankruptcy; ceased with loss to creditors after such actions as execution, foreclosure for attachment; voluntarily withdrew leaving unpaid obligations; were involved in court actions such as receivership, reorganization or arrangement; or voluntarily compromised with creditors."

(Source: The Business Failure Record, 1980; published by the Dun & Bradstreet Corporation, page 3.)

While this definition is pragmatic it is less comprehensive than other concepts of business failure. A more inclusive concept of business failures would include firms that ceased operation with a loss to the owners, even if the creditors did not suffer a loss. Economists might argue for an even broader definition which views a business failure to occur whenever a firm earns a rate of return on investment which is less than the opportunity cost from other forms of investment. However, I would underscore the view that the pragmatic definition used by Dun & Bradstreet is useful and well accepted, even in view of these alternative concepts. This definition is particularly useful for evaluating the classical economic problems relating to business failures; the secondary effects on relatively innocent bystanders. (It should be noted that the definition of business failure in the McGraw Hill Dictionary of Modern Economics is "The cessation of operations by a business concern because of involvement in court procedures for voluntary actions which will result in loss to its creditors." (Source: McGraw-Hill Dictionary of Economics, 2nd edition, New York, McGraw-Hill, 1973; page 66.)

SOURCES OF DATA AND METHOD OF COLLECTION

The data published by the Dun & Bradstreet Corporation are collected by reporters employed by the Operations Division of the Dun & Bradstreet Corporation. The reporters work in branch offices located throughout the U.S. Data on court actions are obtained from daily checks of the court records; an activity which is an essential part of the credit reporting function of our business. Data on non-court actions are obtained from a variety of sources such as scanning of auction and foreclosure notices, contacts with local Boards of Trade and Credit Managers Associations, as well as from the reporters' rounds of regular interviews in the process of preparing business information reports on millions of individual businesses. (We maintain an active file on nearly 5 million businesses in the United States.)

The information is sent from each office to the Business Economics Division in New York. For each case, a questionnaire is prepared by the branch office reporter and combined with copies of notice regarding failure actions and the complete Business Information Report on the business. These reports are edited and coded by The Business Economics Division.

A preliminary weekly recapitulation is made manually using two liability size groups, five operational functions, and nine major geographic regions. This weekly report is prepared and mailed to news media and to subscribers.

At a later date (after followup with branch offices for omissions, inconsistencies. and revisions) a monthly computer analysis is prepared showing a breakdown by major lines of business, by state and regions, largest cities, liability size groups, Federal Reserve districts by function, as well as Dun's Failure Index, adjusted and unadjusted, showing apparent annual failure rate per 10,000 listed enterprises. These reports are also made available to news media and to subscribers.

In addition, there is a quarterly report to subscribers which provides a more detailed breakdown by line of business (3 digit level in the Standard Industrial Classification—S.I.C.—and in some instances 4 digit level of the S.I.C.). Annually, a booklet is prepared which shows the historical trend in numbers, liabilities, rates per 10,000, age distribution, and a summary of causes. The 1980 is provided as an attachment to this statement.

The only size breakdown which we have available is on liability size. We do not have either number of employees of current sales volume figures on all cases since a significant proportion of the businesses which fail are not listed in the D&B information file. As for liability size, approximately 95 percent of the failures involve liabilities of less then $1 million.

COVERAGE OF ANALYSIS

The D&B failure analysis covers businesses of all sizes and of all types of legal organization, i.e., corporations, partnerships and individual proprietorships. A business does not have to be listed in the D&B file to be included provided that it is

engaged in a type of business (commercial or industrial) covered by the analysis. Major areas not included in the D&B file include finance, insurance, real estate, amusement and recreation services, health services, legal services, educational services, social services, museums, membership organizations, private households and miscellaneous services.

Some of the differences between the statistics in the Dun & Bradstreet failure analysis and the bankruptcy statistics of the Administrative Office of the U.S. Courts reflect the differences in coverage which result from the exclusions described above. But, a primary reason for the differences between the two series is that the Courts count case numbers, not businesses. When a partnership files bankruptcy, each partner is assigned a case number. In the case of a large conglomerate, each subsidiary may file separately and thus be assigned separate case numbers. In earlier years, husbands and wives in proprietorships were assigned separate case numbers but now that had been corrected. Still, this change in reporting practice distorts the historical trend in the series of the Administrative Office of the U.S. Courts.

Further, the opinions of a D&B reporter and a court clerk may differ on what constitutes a business operation. In attempting to check on some bankruptcy cases classified as a business, our offices have reported that local directories, banks, etc., show no evidence of such an operation having existed. In other instances, the list of creditors may indicate personal debts rather than business debts.

In earlier years, the Court count of case numbers used to specify broad functional categories. Comparison with these indicated a fairly good correlation on Manufacturing and Merchants but a big proportion of their cases were classified as "Others In Business."

Our series on the number of failures per 10,000 listed firms is based on a comparison of the number of business failures recorded in comparison with the number of firms listed in the Dun & Bradstreet Directory. As a statistician I would quickly note that there are limitations to this approach. First, as noted above, not all businesses are included in our directory. Second, there is no universally accepted measure of business establishments. Many individuals ranging from farmers to housewives to moonlighting professionals have incorporated into proprietorships, partnerships or limited corporations. Some of these activities are not economic in the sense that they are primarily organized for tax purposes. Others are non-economic in the sense that they provide a marginal addition to family income. Still others are anticipatory of future successes in business activity.

One source of statistics on the number of proprietorships, partnerships and corporations is available from the Internal Revenue Service statistics on income. These data are summarized in Table 1 along with estimates of the number of business enterprises listed by Dun & Bradstreet.

In a review of sources of business failure data by the Congressional Research Service, the following conclusions about alternative sources is made: "Thus, it appears that for purposes of analyzing business failures, the Dun & Bradstreet data, despite their exclusion of major business segments and other limitations, are in most respects superior to the bankruptcy data of the U.S. Administrative Office of the Courts." (Source: "Business Failure: A Review of the Concept and its Significance in the American Economy," by Julius W. Allen, consultant and Mark Jickling, reference assistant, Congressional Research Service, the Library of Congress, September 16, 1981; HG 3760US, page 6).

WHAT DOES THE DUN & BRADSTREET DATA SHOW

Statistics on business failure are summarized in our annual publication entitled "The Business Failure Record." I have made available copies of our latest report for 1980. Three tables summarize historic and recent trends. Table 2 summarizes the record of the post-war period.

The failure statistics have been compiled since 1857. A chart of the trend, 1857–1950, has also been provided to the staff of this committee. A chart on page 14 and 15 of the most recent Business Failure Record shows the trend 1920–1980 while page 2 of that report provides the yearly figures from 1925 through 1980.

A record high was reached during the depression of the early 1930's while lesser peaks have been registered since that date in the recession periods designated by the National Bureau of Economic Research. In 1932 the total number of failures equaled 31,822. This resulted in a failure rate per 10,000 listed concerns of 154, over 3½ times the rate calculated for 1981.

The current recession has been accompanied by a sharp increase in the number of business failures. As noted earlier, our preliminary estimates are refined several

months after the initial estimates become available. In fact, we are still completing work on finalizing the 1981 record. It is clear that the number of business failures increased sharply in 1981. The total number of failures increased slightly over 45 percent from the 1980 level which was 55 percent above 1979. This two year increase of 128 percent is the sharpest post war increase since the 1947–49 period when the restructuring of the economy was reflected in a high rate of business failure.

Preliminary data for 1982 show that for the first 23 weeks of this year, the number of reported business failures is 44.3 percent over one year ago.

The pattern by industry and geographic region is also summarized in Tables 3 and 4. In 1981 the greatest increase in the level of failures was in construction, with the services ranked second. During the first 23 weeks of this year the wholesaling and manufacturing section have recorded the largest increase in the level of business failure.

On a regional basis the largest number of failures occurred in the Pacific and the East North Central regions in 1980, 1981 and the first weeks of this year. Because of the high level of failures in these regions the percent change in recent weeks has not been as high for those regions: however the number of failures in these regions remains high.

CAUSES OF BUSINESS FAILURE

Each year Dun & Bradstreet conducts a review to determine some of the reasons for business failures. The results are reported in the Business Record. The classification of causes combines the opinion of some of the largest creditors with the information in the D&B reporter file.

Over the years the review shows that the major reason for business failure is lack of experience. In nine out of ten failures, the lack of managerial experience or aptitude proved to be the underlying factor behind lack of business success. Surprising, this ratio holds relatively steady whether the economy is booming or is falling into a recession.

In 1979, for example, a rising proportion of entrepreneurs either had no previous experience in the line or no previous managerial experience. This was true in all types of operation but it was most noticeable among retailers—over 19 percent ventured into unfamiliar lines and over 17 percent risked starting up new businesses without any managerial knowhow.

This finding should not be interpreted as an offset to the difficulties associated with high interest rates or falling sales levels. As interest rates have remained high, receivables difficulties were cited in a growing number of cases of failure. At the present time, such difficulties are reported in the greatest proportion of cases in a decade.

Heavy operating expenses in the face of sagging sales are also a major cause of failure. While this is partly attributed to lack of management experience and ability to respond to changing conditions, it also reflects the difficulties associated with a depressing economy.

During the past decade there is a general trend that the rate of business failures has declined for businesses with 10 or more years of experience, following an earlier pattern over 20 years for increasing rates of failure among experienced firms. In contrast, the failure rate has picked up for firms with 6 to 10 years of experience. The rate of failure for businesses which have existed less than five years has been relatively stable. More than anything else, these trends reflect the ebb and flow of business by sector and region.

CONCLUSIONS

It is difficult to gain a truly comprehensive picture of business failure because the statistics are influenced by problems of coverage, definition, and reporting accuracy. Nevertheless, it is unquestionable that a growing number of businesses are unable to survive in a recession with high interest rates. While the levels and rates of failure at this time are not abnormal, it is clear that a prolonged recession will have a heavy toll on the business population.

Tight credit and effective cost controls are likely to dampen the business recovery as businesses remain cautious following the difficulties of two back to back recessions and continuing lackluster economic performance.

In the longer term, the present low levels of housing activity, auto sales, and consumer durables suggest that basic demand exists for a sustained business recovery. Recently enacted investment incentives also create a framework for economic recovery. However, lower costs of capital (lower interest rates) are clearly essential before

the consumer or the investor makes strong positive moves.

TABLE 1.—ESTIMATES OF BUSINESS POPULATION, 1955–78

[All numbers in thousands]

	Number of [1]			Estimated number [2]
	Proprietorships	Partnerships	Corporations	
1955	8,239	([3])	807	2,644
1960	9,090	941	1,141	2,702
1965	9,078	914	1,424	2,533
1970	9,400	936	1,655	2,443
1975	10,882	1,073	2,024	2,676
1976	11,358	1,096	2,082	2,759
1977	11,346	1,153	2,241	2,782
1978	12,018	1,234	([3])	2,762

[1] Based on U.S. Internal Revenue Statistics of Income.
[2] Dun & Bradstreet publishes both the number of business failures and the rate of failure per 10,000 listed enterprises. The business population estimates in this column are derived by dividing the number of business failures by the failure rate.
[3] Not available.

Data from: Internal Revenue Service and the Dun & Bradstreet Corp.
Source: This table is reproduced from Congressional Research Service Report No. 81–195 E, "Business Failure: A Review of the Concept and its Significance in the American Economy," by Julius W. Allen with the assistance of Mark Jickling, Sept 16, 1981, HG 3760 U.S., p. 5.

TABLE 2.—HISTORICAL TREND IN BUSINESS FAILURES

Year:	Number of failures	Total failure liabilities	Failure rate [1]	Average liability per failure
1945	809	30,225,000	4	37,361
1946	1,129	67,349,000	5	59,654
1947	3,474	204,612,000	14	58,898
1948	5,250	234,620,000	20	44,690
1949	9,246	308,109,000	34	33,323
1950	9,162	248,283,000	34	27,099
1951	8,058	259,547,000	31	32,210
1952	7,611	283,314,000	29	37,224
1953	8,862	394,153,000	33	44,477
1954	11,086	462,628,000	42	41,731
1955	10,969	449,380,000	42	40,968
1956	12,686	562,697,000	48	44,356
1957	13,739	615,293,000	52	44,784
1958	14,964	728,258,000	56	48,667
1959	14,053	692,808,000	52	49,300
1960	15,445	938,630,000	57	60,772
1961	17,075	1,090,123,000	64	63,843
1962	15,782	1,213,601,000	61	76,898
1963	14,374	1,352,593,000	56	94,100
1964	13,501	1,329,223,000	53	98,454
1965	13,514	1,321,666,000	53	97,800
1966	13,061	1,385,659,000	52	106,091
1967	12,364	1,265,227,000	49	102,332
1968	9,636	940,996,000	39	97,654
1969	9,154	1,142,113,000	37	124,767
1970	10,748	1,887,754,000	44	175,638
1971	10,326	1,916,929,000	42	185,641
1972	9,566	2,000,244,000	38	209,099
1973	9,345	2,298,606,000	36	245,972
1974	9,915	3,053,137,000	38	307,931
1975	11,432	4,380,170,000	43	383,150
1976	9,628	3,011,271,000	35	312,762
1977	7,919	3,095,317,000	28	390,872
1978	6,619	2,656,006,000	24	401,270

TABLE 2.—HISTORICAL TREND IN BUSINESS FAILURES—Continued

	Number of failures	Total failure liabilities	Failure rate [1]	Average liability per failure
1979	7,564	2,667,362,000	28	352,639
1980	11,742	4,635,080,000	42	394,744
1981	17,044	([2])	62	([2])

[1] Per 10,000 listed concerns. [2] Not available.

TABLE 3.—PRELIMINARY REPORT OF FAILURE TRENDS, YEAR 1981 VERSUS 1980

[Failures by size, function, and region]

	1981	1980	Percent change
U.S. total	17,044	11,742	+45.2
Liabilities:			
$100,000 and over	8,516	6,060	+40.5
Under $100,000	8,528	5,682	+50.1
Function:			
Manufacturing	2,249	1,599	+40.7
Wholesaling	1,738	1,284	+35.4
Retailing	6,981	4,910	+42.2
Construction	3,674	2,355	+56.0
Services	2,402	1,594	+50.7
Region:			
New England	547	464	+17.9
Middle Atlantic	2,381	1,580	+50.7
East North Central	2,770	2,091	+32.5
West North Central	1,313	883	+48.7
South Atlantic	1,783	1,127	+58.2
East South Central	1,149	841	+36.6
West South Central	1,670	1,378	+21.2
Mountain	649	416	+56.0
Pacific	4,782	2,962	+61.4

Source: Weekly Failure Report, Business Economics Division, Dun & Bradstreet.

TABLE 4.—RECENT BUSINESS FAILURE TRENDS

[First 23 weeks 1982 versus 1981—Preliminary]

	1982	1981	Percent change
U.S. total	10,430	7,226	+44.3
Liabilities:			
$100,000 and over	5,421	3,618	+49.8
Under $100,000	5,009	3,608	+38.8
Function:			
Manufacturing	1,517	967	+56.9
Wholesaling	1,125	719	+56.5
Retailing	4,116	3,016	+36.5
Construction	2,122	1,499	+41.6
Services	1,550	1,025	+51.2
Region:			
New England	300	253	+18.6
Middle Atlantic	1,436	988	+45.3
East North Central	1,727	1,233	+40.1
West North Central	809	571	+41.7
South Atlantic	1,126	774	+45.5

TABLE 4.—RECENT BUSINESS FAILURE TRENDS—Continued

[First 23 weeks 1982 versus 1981—Preliminary]

	1982	1981	Percent change
East South Central	749	494	+51.6
West South Central	947	727	+30.3
Mountain	517	210	+146.2
Pacific	2,819	1,976	+42.7

Source: Business Economics Division, Dun & Bradstreet.

Mr. ROEMER. We will now hear testimony on behalf of the National Small Business Association by Herbert Liebenson.

Herbert, please proceed.

TESTIMONY OF HERBERT LIEBENSON, PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. LIEBENSON. Thank you.

My name is Herbert Liebenson. I am president of the National Small Business Association, a multi-industry trade association representing approximately 50,000 small business firms nationwide. I also serve as executive director of the Small Business Legislative Council, which is made up of 72 national trade associations, and which represents 4.5 million small firms.

I first want to digress a moment to say how privileged I am to be at the same table with Joe Duncan. Joe is one of the unsung heroes that in a former life in the Office of Statistical Standards of the Office of Management and Budget saved the business community, and especially the small business community, millions and millions of dollars of unnecessary reporting requirements that many of the agencies had wanted to force onto the business community. He was one of the major stopgaps for that heavy reporting.

It has often been said that the strength of a democratic society is directly related to the strength of its small business community. Two essentials for the United States to remain strong and the leader of the free world are a viable small business sector of the economy and superior educational opportunities for its young people: Small business because this is the lifeblood of our economic and industrial growth, and superior education because this feeds both the mind and body that make all other things possible.

Unfortunately, today both these essentials are being neglected. The bankruptcy rate for small businesses is now near an alltime high. There is much talk about the plight of small firms but still their particular needs get little positive attention, relatively speaking, in the formulation of Government economic policy.

Last year, about this time, the members of your committee discussed major small business issues. We flagged the issue that the business bankruptcy rate was a barometer of the status of the economy.

In our September 1981 report, which is attached, we issued a report on business bankruptcies that tied bankruptcies directly to high interest rates. It showed there was a 75-percent correlation between the level of interest rates and the level of bankruptcies. The high interest rates prohibited the financing of inventories and the

extension of credit to customers. About 10 percent of all the automobile dealers and agricultural implement dealers were forced out of business. The construction industry, almost totally dependent on credit, has been decimated. In our testimony to the Ways and Means Committee on revenue enhancement, we cited a Wall Street Journal article that discusses the possible restructuring of the home building industry that up until now has been the citadel of small business.

We have updated our figures. The rate has more than doubled since 1980 and is three times the rate of 1979. The point that has not been made is that it isn't the marginal companies that are now going under. These disappeared a long time ago. It is the healthier, well-managed firms with a legitimate niche in the marketplace that are now the victims. There is evidence that the trend is increasingly affecting larger companies as well as smaller ones. The percentage of failing companies with liabilities of over $100,000 has edged up from 48.9 percent in 1980 to 50 percent in 1981 to 51.8 percent for the first 8 weeks of 1982. Yet it is the small businesses that we must look for relief from the current deplorable unemployment problem. I might refer you to page 5 of our attachment, which talks about the human dimension of the bankruptcies, to which the chairman alluded earlier.

It is also on small business that we rely most for our new inventions and innovative ideas. Without this understanding and appropriate implementation, the Nation's capacity to improve productive output, and indeed to remain competitive in technological ability will suffer disastrous consequences.

The longer Government allows these conditions to exist, unemployment will increase, innovation will decrease, and overall economic performance will suffer.

Thank you for the opportunity to appear before you.

Mr. LAFALCE. Thank you, Mr. Liebenson.

Mr. Duncan, I regret the fact that I had to be absent during your testimony. I know you gave testimony regarding the horrendous number of business failures today in comparison with our historical past is unparalled since the Great Depression. Did you go into the question, though, of the type of businesses, the fact that the failures may well be failures of old, established businesses rather than new businesses and rather than marginal businesses?

Mr. DUNCAN. Mr. Chairman, the items I have in hand show the business failure record of 1980, and summarize the statistics for each year in terms of the characteristics of the businesses that are failing; that is, their size in terms of the total liability at risk, their age, and their geographic location.

[The material referred to above follows:]

REPORT ON BUSINESS BANKRUPTCIES

Prepared by National Small Business Association -- September 21, 1981

Business Failures: Current Statistics

From mid-1980 to mid-1981 court-filed business bankruptcies increased 30.1 percent. This is the second largest year-to-year rise of the past 20 years, below only the 45.2 percent increase occurring between 1974 and 1975.

Even more alarming are more current figures from Dun & Bradstreet for January 1 through September 3, 1981, which reflect that business bankruptcies increased from 7,812 to 11,076, a jump of 41.8 percent compared with the same 35 week period in 1980, according to press reports quoting Rowena Wyant, a D&B Vice President in the New York business economics division ("Business Failures Increase," New York Times, September 13, 1981.)

Smaller businesses (defined as those with liabilities of $100,000 or less) comprised 50.53 percent of the 1981 total.

An industry breakdown of the D&B figures for the 35-week period is as follows:

	1981 Compared to 1980
Construction	up 48.5%
Services	up 47.6%
Retailing	up 41.4%
Manufacturing	up 36.9%
Wholesaling	up 30.1%

This information is probably conservative from the small firm standpoint, because D&B figures do not include the finance, insurance, and real estate fields where smaller businesses predominate.

In a recent newspaper column George Will characterized similar figures as "a massacre on Main Street." (The Massacre on Main Street," Washington Post, September 20, 1981, page C8:1)

The court filings are on the basis of the "statistical year" of the U.S. Courts which record the information, which for the past two years has been as follows:

Statistical Year	July 1, 1979 - June 30, 1980	= 36,433
Statistical Year	July 1, 1980 - June 30, 1981	= 47,414

Notes

As a technical matter, it should be noted that courts also accept Joint Petitions. These are additional filings where the husband and wife both participate in the enterprise. These are excluded from the above figures, because a "joint petition" covers persons associated with a business that has already filed. Inclusion of joint petitions would increase the business total for the 1980-81 statistical year to 66,000.

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The statistics are also affected by changes in the bankruptcy laws brought about by the Bankruptcy Reform Act of 1978 (effective October 1, 1979). The new code did not make it easier for corporations to file. The law did establish a series of personal exemptions in federal law for the first time which, in many instances, were more liberal than state laws. (Bankruptcy Code, Sec. 522). However, there were not and are not any corporate exemptions, and corporations can no longer be discharged of debt as they could under the old law.

Historical Trends

The statistics on bankruptcies since 1950, as collected by both the U.S. Courts and Dun & Bradstreet are set forth in a chronological table attached as Exhibit 1.

The data show that business bankruptcies have risen and fallen in cycles. From mid-1961 through mid-1970, court-filed bankruptcies by businesses held almost constant (averaging about 16,200 per year, or 1350 per month). Then from mid-1971 to mid-1976, the figure more than doubled to 35,201 (about 2900 per month). Thereafter, the level declined until the end of 1979, when it stabilized at about 2,500 per month, as shown in the following table:

Court filed bankruptcies mid-1975 to mid-1979

1975-76	35,201
1976-77	32,189
1977-78	30,528
1978-79	29,500

Within a few months after the Federal Reserve action of October 1979 boosted interest rates to then-record levels, business bankruptcies began to climb dramatically. Totals reached an average of about 3,800 per month in the spring of 1980, where they remained until this year (1981) when they hit a new plateau of about 4,000 per month. This can be seen in the following quarterly tabulations:

	July-September	October-December	January-March	April-June
Statistical Year 1980-81	11,674 ('80)	11,227 ('80)	12,101 ('81)	12,081 ('81)
Statistical Year 1979-80	8,457 ('79)	7,014 ('79)	9,137 ('80)	11,473 ('80)

Thus, the business bankruptcy level increased 63.57 percent from the beginning of October, 1979 to the end of June, 1980.

Particularly Hard-Hit Industries

Some industries are particularly hard hit, such as construction. According to Dun & Bradstreet, bankruptcy rates for building contractors and subcontractors increased 48.5 percent through September 3, 1981 over the same period in 1980 (by which time the casualty figures had already risen substantially from the 1979 lows.)

A break-out of comparable figures for the first three months of this year shows:

Failure in Building and Construction

	January-February-March 1981	January-February-March 1980	Increase #	Increase %
General Building Contractors	282	228	54	23.68
Building Subcontractors	358	218	140	64.22
Other Contractors	45	22	23	104.55
	685	463	222	47.95

Source: Dun & Bradstreet, New York.

In automobile distribution, 1650 new car dealers went out of business in 1980, the largest total ever. Another 325 have failed during the first 6 months of 1981, bringing the overall exodus close to 9 percent of all businesses in this field since 1979 (NADA Data for 1981, National Association of Automobile Dealers).

"Walkaways"

There are also innumerable instances when businesses just close their doors and terminate the business. They may now owe creditors nothing. Or, they may have substantial debts which are satisfied through attachments on bank accounts or foreclosing tax liens or mortgages, leaving few assets for general creditors to pursue in any kind of formal proceeding. There is probably no overall source of statistics on these "walkaways," but experts believe the number is substantial.

Relationship Between Individual Bankruptcies and Business Bankruptcies

Court-filed bankruptcy rates for individuals have more than doubled since the new bankruptcy code became effective in October 1979:

Non-Business Bankruptcies

1978-79	196,976
1979-80	314,856
1980-81	450,000 (preliminary)

These personal bankruptcies have direct ramifications for small business.

When an individual declares bankruptcy, the creditors are left "holding the bag," which is almost always empty.

Prominent among these creditors are the retailers, distributors, builders and service enterprises where the bankrupt ran up the bills which caused the problems. Many of these are small business.

For example, the May Company reported 1980 losses increasing 103.3 percent to $3.6 million compared to 1979. For J.C. Penney, losses increased 102 percent to $20.7 million. Montgomery Ward's losses increased 117 percent to $50.6 million, while Sears' losses increased 120.4 percent to $46.2 million for the same period.

Local businesses have the same kind of trouble. In fact, some of the regional independent stores, which are members of the National Retail Merchants Association, reported 1980 losses increasing over 200 percent compared to 1979.

Relationship Between Interest Rates and Bankruptcies

These cycles raise the question of how interest rates affect bankruptcies. As can be seen from comparing interest rate movements with the bankruptcy cycles documented by Dun & Bradstreet and the U.S. Courts, bankruptcies have tracked the interest rate very closely in recent years. This is illustrated by the chart attached as Exhibit 2, which was prepared by the Small Business Committee of the U.S. House of Representatives.

In technical terms, the correlation between real interest rates (e.g., the nominal rate minus the inflation rate [GNP deflator] was 74.5 percent during the 3-year period coverd by the chart and 73.47 percent for the 5 years from 1976 to 1981. Economists say that 74 percent constitutes a "direct and significant correlation" between these two factors.

Higher interest rate movements can affect a business directly and indirectly in several ways. They add to the costs of financing the production, distribution, inventorying and sale of merchandise. They are also a factor in willingness of consumers to purchase the product.

Interest rates also impact general economic conditions with multiple effects on small firms.

A statistical "correlation" does not spell out how two factors relate to each other or what other factors may be involved. But a correlation does indicate some kind of a relationship -- in lesser or greater degree -- and a correlation as high as 74 percent indicates the relationship is close and meaningful.

The plight of industries composed mostly of small firms which are particularly sensitive to interest rates -- such as builders and auto dealerships -- tend to confirm this relationship.

Thus, as long as interest rates remain at record rates, it can be expected that bankruptcies will also continue to set new records.

Effects on Employment

The fifteen million small firms in the U.S. which file tax returns account for 55 percent of existing employment (59 percent if farming is included) and

approximately 80 percent of all new jobs. Professor David Birch of M.I.T. found that independent enterprises with 20 or fewer employees accounted for 52 percent of net new private sector jobs between 1967 and 1976. Thus, as bankruptcies increase among small firms, job generation may be inhibited, existing jobs threatened, and increased unemployment may result.

Since each one percent increase in the unemployment rate (approximately equal to one million persons) deprives the U.S. Treasury of $25 to $29 billion in tax revenues foregone and benefits paid, increased bankruptcies -- especially among small businesses -- can translate into larger budgetary and economic problems.

The Human Dimension of Bankruptcies

Several years ago, a doctor at Johns Hopkins University researched the social effects of unemployment ("Estimating the Social Costs of National Economic Policy: Complications for Mental and Physical Health" by Professor Harvey Brenner, Joint Economic Committee Print, October 26, 1976).

This study found that during periods of higher unemployment, use of alcohol, hospitalization, suicides, heart attack and kidney disease also showed statistical increases.

Such an analysis could apply not only to employees, but to small busines: owners. Entrepreneurs would also be subject to great financial and personal stress in attempting to save businesses in which they have invested a significant amount of their savings and their careers, especially if these efforts were unsuccessful.

According to an attorney who has practiced bankruptcy law for 42 years, Samuel Greenbaum of Washington D.C., many small businesses are under-capitalized to begin with. As a result, such owners are often required to put up personal assets such as their homes as additional security for business loans. If a bankruptcy follows, an owner can also have his family life shattered, exacting a "toll of personal tragedy".

The surge in business failures is therefore of great concern for both economic and social reasons.

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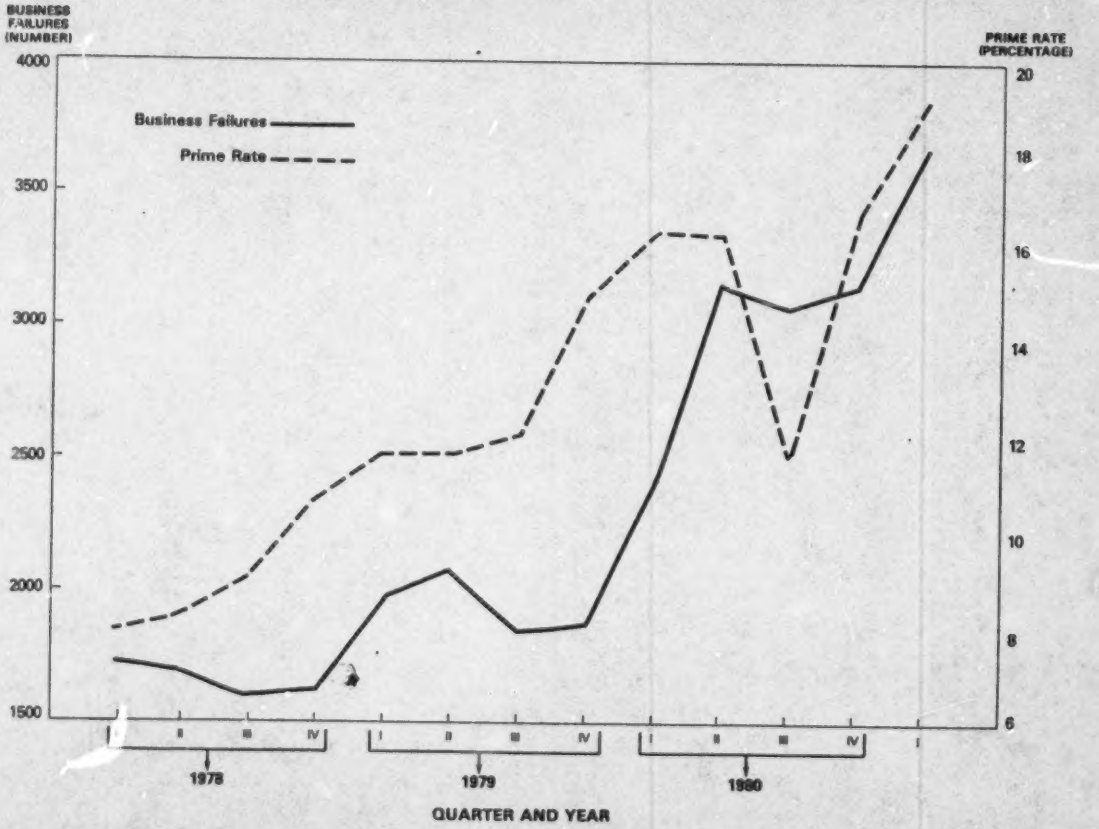
Exhibit 1

BUSINESS FAILURES

According to U.S. Courts		According to Dun & Bradstreet	
1950	8,352	1950	9,162
1951	7,387	1951	8,058
1952	6,542	1952	7,611
1953	6,772	1953	8,862
1954	8,888	1954	11,068
1955	9,185	1955	10,969
1956	9,478	1956	12,686
1957	10,144	1957	13,739
1958	11,403	1958	14,964
1959	11,729	1959	14,053
1960	12,284	1960	15,445
1961	15,241	1961	17,075
1962	15,665	1962	15,782
1963	16,303	1963	14,374
1964	16,510	1964	13,501
1965	16,910	1965	13,514
1966	16,430	1966	13,061
1967	16,600	1967	12,364
1968	16,545	1968	9,363
1969	15,430	1969	9,154
1970	16,197	1970	10,748
1971	19,103	1971	10,326
1972	18,132	1972	9,566
1973	17,490	1973	9,345
1974	20,747	1974	9,915
1975	30,130	1975	11,432
1976	35,201	1976	9,628
1977	32,189	1977	7,919
1978	30,528	1978	6,619
1979	29,500*	1979	7,564
1980	36,443*	1980	11,742
1981	47,414*	1981(thur Sept. 3)	11,076

* Exclusive of Joint Petitions

BUSINESS FAILURES AND PRIME RATE



SOURCES: FEDERAL RESERVE BULLETIN, DUN & BRADSTREET

Exhibit 2

UPDATE ON BUSINESS BANKRUPTCIES

For the 21-week period January 1-May 27, 1982 business failures tabulated by Dun and Bradstreet stood at 9,511.

This represents an increase of nearly three-fourths over the comparable period of 1981 and is more than twice the total for the same 21-week period of 1980.

21-week period for Calendar Years:		Increases From Prior Year	Two Years Ago
1982	9,511	86.5%	115.8%
1981	5,100	15.7%	
1980	4,407		

On an annualized basis, the 9,511 figure for 21 weeks is comparable to 23,511, according to a simple straight line projection. For the four weeks in May, the actual rate has been running ahead of that figure -- at a rate of 24,830.

The annualized 21-week total for 1982 would compare to past years as follows:

Year	Number of Failures	Failure Rate Per 10,000 firms
1982	23,551 (annual rate)	-
1981	17,043	62
1980	11,472	42
1979	7,564	28
1978	6,619	24
1961	17,075*	64
1935	12,244	62
1934	12,091	61
1933	19,859	100
1932	31,822	154

*Previous Post-War II high

There is evidence that the trend is increasingly effecting larger companies as well as smaller ones. The percentage of failing companies with liabilities of over $100,000 has edged up from 48.9% in 1980 to 50.0% in 1981 to 51.8% for the first eight weeks of 1982.

In addition, there have been highly publicized cases of large corporations filing Chapter XI bankruptcies, including AM International, Braniff Airlines, Saxon Industries, White Motors and Wickes Company.

One of the side effects of bankruptcies is in the pension area. If Braniff terminated its five pension plans, it might add 67¢ to $1 to the current request of the Pension Benefit Guaranty Corporation for a $6 per person premium. If Chrysler and International Harvester failed, the premium could rise to $20. ("Corporate Failures Burden Pension Insurance Agency" by Nancy Ross Washington Post, May 15, 1982, Page D8).

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June 15, 1982

Mr. LAFALCE. Which table, Mr. Duncan?

Mr. DUNCAN. There are a series of tables at the back of that report. One table is on the region. One is on size and age. The point that I would make from the tables is that the increase in the number of business failures is not restricted to a particular sector of our economy, either by region or by a particular class in terms of size. It does turn out, incidentally, that if you look at the liabilities, those failures which involve less that $25,000 have been a decreasing proportion of the total number of failures. But part of that is an inflationary factor.

On the basis of age, the very young firm tends to survive for a period. Older firms tend to survive. It is the firm of intermediate age where the problems finally come together to yield higher proportion of failure. There has been a declining trend in the number of failures of the established firms. Part of that is because they merged, rather than failed. The concentration of failures in terms of age group is under 10 years and over 3 or 4 years.

There are differences in failure rates by region. The east and north central part of our country has more economic difficulty than other regions of our country. However, if you look at the statistics and don't worry about differences of 5 or 10 percentage points—which are really not statistically that important compared with the 40-percent increases that are evident—you would conclude that the failure of business is pervasive in all industries, all regions, and all age categories.

Mr. LAFALCE. Let me ask both of you to comment on this concern of mine. We are experiencing, in addition to unprecedented bankruptcies and business failures since the Great Depression, unemployment percentages unprecedented since the Great Depression also.

Now, ordinarily, we have rebounds from high unemployment, but usually that is because the unemployment has been caused more by layoff from ongoing concerns than by the elimination of the concerns, and simultaneously, the elimination of the jobs. I am wondering if there is some type of correlation that we could quantify between the business failures and the expectations for recovery from this high unemployment we are experiencing.

Mr. DUNCAN. Mr. Chairman, I would like to make two comments on that. The first comment is that when you look at the anatomy of unemployment today, the layoffs of the larger firms are by far the dominant feature: the big industries of steel and autos and construction.

Mr. LAFALCE. The difficulty with those large firms is even if there is an economic recovery due to the technological revolution, they probably will not be rehiring those people they laid off.

Mr. DUNCAN. They will not rehire at the same rate. I think there is no question about that. Regardless of the strength of recovery, a number of sectors have become inflation conscious. They are going to keep their employment rolls as tight as possible. They are going to be cost conscious. For the total health of the economy that is good. For the unemployed person, that is tough.

Now, let me turn to the other side of the unemployment picture, which almost nobody pays attention to today. Over the last decade and a half, we have experienced impressive increases in the propor-

tion of the population seeking work. The dramatic part is women returning to the labor force, but there are also younger people seeking part-time jobs as they try to earn their education.

One number is very impressive: There are 20 million more people employed today—even with the high unemployment rate—than we had 10 years ago. A large number of jobs are now in place. We have a higher percentage of unemployment, in part, because we have a higher percentage of people seeking work. One might identify some of those people as marginal workers. However, most of them are real workers.

Mr. LAFALCE. Are you suggesting that things aren't as bad as the statistics would lead one to believe?

Mr. DUNCAN. It is clearly the case that things are not so bad as the high rates would lead you to believe, since personal income is continuing to increase. Let me explain the problem in a different sense. Why do we have so many people seeking work? We have gone through a decade of very high inflation where family units maintained their standard of living in face of rising prices by sending a second worker into the workplace.

You may wonder why we don't hear more outcries about unemployment. The fact is that for many families with an unemployed worker, somebody else is still at work. They still have income, unlike the condition of a couple decades ago. At that time, when the primary wage earner lost a job, the unemployment benefits were not as good, and nobody else in the family was earning income.

I am not trying to say that there are no problems with unemployment. I am saying we don't look at the positive side of the labor force picture as much as we look at the negative.

Mr. LAFALCE. Well, there are a number of questions that I want to ask to followup on that. Mr. Liebenson, did you want to comment?

Mr. LIEBENSON. Well, let me put it this way. Not too long ago, I was meeting with a high administration official and I raised the question of why the major companies were not utilizing the liberal depreciation rules that were given to them in the last tax bill. And they said basically that they weren't utilizing these incentives because their current capacity would allow them to meet any demand and, until demand increases, that the companies had no incentive to build new plants and to purchase new equipment. So, we get back to the demand side again, which gets back to the great number of unemployed and, basically, unless we start providing jobs to those unemployed, that demand will not increase, and therefore the economy cannot get moving again.

So, to me, the basic problem is with the numbers of unemployed. For years, we have been trying to get back to a general job creation tax credit, which is something that we will still continue to look for and I think will be absolutely necessary because this current budget does not do enough for those who are unemployed. It is going to be directed, as I understand it, to about 22 areas where people are unskilled, where they don't have enough individuals in those particular skills.

But the great numbers of the unskilled or those coming from the auto industry and other industries with just a few skills that are

not transferable to other industries will not be hired again by these companies, mainly because those jobs will be replaced by mechanization and roboting and we will see unemployment as a long-term problem.

Mr. LAFALCE. I am very, very concerned about that, Mr. Liebenson. I strongly believe that when we look at the large industrial concerns of America that have laid off so many workers, we find that they are not going to be rehiring very high percentages, even in a recovery, because of the changes they will make to adapt to the technological revolution we are experiencing now. I am also concerned that small businesses will simply not be around in adequate enough numbers to rehire the number of individuals that they have laid off. The few they haven't laid off, they have just eliminated because they have actually failed, rather than just minimized their operation.

But let me go back, Mr. Duncan, to the point that you made. You were talking about the statistics today as perhaps not being as dreadful as they were before because of the larger percentage of the population seeking employment in the work force in comparison with the past because of various reasons, whether it was personal income, social mores, changes, or what have you. Do we have any indicators of the percentage of unemployed individuals using the number of potentially employables, as opposed to those seeking employment?

Mr. DUNCAN. Well, Mr. Chairman, you are touching on one of the great debates in the labor economics profession, which is the discouraged worker concept and who is looking for work and who is eligible for work.

Mr. LAFALCE. No, no. I am not getting to that. I know what you are saying. That goes to the one side of the equation. What I am looking at is—and that is a very important issue—not those that are seeking work. What I am talking about now is the base figure that you are using. You are saying that right now we have more people seeking employment and, therefore, we have a higher percentage of unemployment on account of that than we would have had in the past when fewer people were seeking employment.

Mr. DUNCAN. Can I put it in statistical terms for you?

Mr. LAFALCE. Am I correct?

Mr. DUNCAN. Right. The problem——

Mr. LAFALCE. Let me just finish my thought and then you can put it in statistical terms. Let me put it in statistical terms. We had 10 people 20 years or so ago: 5 of them were children and 5 of them were adults and we only had 2 of the 3 adults looking for work, because three were women and wanted to stay in the home. Today, we have 10 people: 5 children and we have 5 adults and we have 4 of those 5 looking for work: 2 males, 2 females and 1 female who could look for work—who is employable—but who is not looking.

Do we have data that will enable us to make a comparison between today's phenomena and the phenomena of 20 years or so ago?

Mr. DUNCAN. Yes; we have data but there are some difficulties in the analysis. Let me put it in rather simple terms. There are two things that cause labor force growth: The first is a change in the

population of labor force age, the demography of our population. The second is the percentage of those people who are working.

To illustrate, let's assume for each age group, each 5-year age group, that the same percentage were seeking work today that were seeking work 10 years ago. Next make a second assumption that the number of jobs available in the economy would be the same. Under these assumptions the unemployment rate would drop 3 percentage points from present levels.

Mr. LAFALCE. Three percentage points?

Mr. DUNCAN. Yes.

May I add one more thing, if you don't mind, Mr. Chairman? These are pessimistic economic times and I apologize for trying to be an optimist about it, but let me look ahead a little bit at our labor force.

During the past 10 years, our labor force grew because of the baby boom, as well as the increased participation by 2.3 million persons per year on the average. In this decade it is presently growing at 1.1 million persons per year and in the second half of the decade will grow at 750,000 persons per year.

Now, let's take that environment and project an economic growth situation that will generate some more jobs. Clearly, if the labor force is not growing as rapidly as it did during the last decade and job opportunities increase in a similar fashion to what they did in the last decade, the rate of unemployment is going to drop rapidly

Mr. LAFALCE. That is very interesting. You made a bit of a forecast there. Have you made any forecasts for business failures for the balance of 1982, and perhaps 1983?

Mr. DUNCAN. Mr. Chairman, no, I do not forecast those numbers directly. The extrapolation that I made a few moments ago is that with the type of year-to-year change that we are presently seeing, rates in the order of 85 to 90 failures per 10,000 would be an expected result.

Mr. LAFALCE. Now, that clearly is the highest figure since the Great Depression. You distinguished between unemployment now and unemployment some years prior and said that the same percentage figure would not be as bad today as it was then. Is there any reason to believe that the same number of business failures per 10,000 today as in the time of the Great Depression is not as bad, is about the same or is worse?

Mr. DUNCAN. Let's first get some perspective on the Great Depression. In 1932 the rate of business failures, that is the number per 10,000, was three times what we are talking about today.

Mr. LAFALCE. What was it?

Mr. DUNCAN. It will be the highest since 1932, but in 1932 it was a very high rate. It was 154.

Mr. LAFALCE. 154?

Mr. DUNCAN. Right.

Mr. LAFALCE. What was it in 1933?

Mr. FREED. One hundred.

Mr. LAFALCE. Thank you.

Mr. DUNCAN. I explained that our statistics are deficient in terms of really knowing the correct number for the total population of business firms. Unfortunately, we don't have any informa-

tion to estimate the total population that would have been in existence in the Depression or even 10 years ago compared to what we have now. For example, today tax laws make it an incentive for people to establish, to incorporate, what might economically be called a marginal business. So, it is hard to compare one period of economy activety with another.

One thing you can do is look at the liabilities that are incurred by the failures and compare those over time. The numbers that you have in the tables are raw numbers. They are in nominal money terms. If you deflate those numbers by the amount of inflation that has occurred you get a less serious picture.

Now, the issue there is what do you deflate it by. I mean, do you use the Consumer Price Index? That really doesn't make much sense to individual businesses because that is designed to look at the market basket of consumer purchases. Within the Producer's Price Indices, there are a whole set of series, each one of which should be applied to each industry that is affected, the steel index, the auto index, and so forth.

I have not made an analysis sector-by-sector, but I think it is quite clear that with the amount of inflation that we have had over the last decade that the liabilities' growth in real terms as it is in the nominal terms in these tables.

Mr. LAFALCE. Mr. Liebenson, would you care to comment on that?

Mr. LIEBENSON. Not comment on that directly, but I think we ought to start looking at some of the possible cures. The basic problem here is capital and capital formation. We have a situation today where most of the new capital, at least that generated by pension funds, by the IRAs and others, is being handled by the banks, insurance companies and, of course, mutual funds, which are the institutional investors that purchase about 70 percent of the securities on the New York Stock Exchange.

You also have the prohibitive transaction section through the Internal Revenue Code that does not allow for much of the pension money or the new IRA money to come back into the small business community. I believe that some avenues have to be opened, some liberalization of those rules have to be made in order to bring more capital into small business and reduce those failures.

I have been told that there is something like $200 billion in money market funds which are not counted as part of the money supply by the Federal Reserve accounting and I guess, if counted, that would affect the M1's. So, we must look to these sources of capital for the smaller business people that I feel will eventually be the answer to easing this recession.

Mr. LAFALCE. Very good. Mr. Duncan, did you have any comments you wanted to make?

[No response.]

Mr. Roemer, I have questioned both Mr. Duncan and Mr. Liebenson. You have heard their testimony. Do you have some questions you would like to ask of both of them?

Mr. ROEMER. Yes, briefly, Mr. Chairman. Sorry for my absence. Like the chairman, I have had three or four irons in the fire all morning.

Mr. Duncan, you said you wore several hats, one of which was as an economist and in my absence—and you might just give a "yes" or "no"—did you discuss your feeling as to the statistics you have accumulated in your organization for years now, how they are going to be effective if the policy of high interest rates continue for an indefinite period of time?

We heard testimony prior to yours that the evidence showed that the rate of failure would probably increase and perhaps significantly if these high interest rate policies were to continue. Do you agree with that assessment or could you address that question?

Mr. DUNCAN. Mr. Chairman, I indicated I have not made a forecast or a model as Professor Altman has, but it is clear from our trends to date for this year that we will have a level on the order of the 85 to 90 failures per 10,000, which is in line with both the chairman's comments in the introduction and Professor Altman's statement.

It is also clear that the major source of business failure when we talk to creditors, is weak management: lack of training, lack of experience. One of the things that the management does poorly is managing their capital resources, that is, in the face of falling sales, cutting back on operating expenses and in the face of high interest, of being able to pay their interest bill.

I have no difference with the view that high interest rates are creating a severe burden on business, as well as on the consumer, and that high interest rates are holding back the business recovery and will do so until they fall. I also share the view that real rates are abnormally high.

You discussed with Professor Altman a number of the pessimistic points, but in your absence, I have been trying to be a bit more optimistic. Let me give you a little optimism on the interest rate question.

Mr. ROEMER. I need it. Go ahead.

Mr. DUNCAN. I need it, too. I am in the home market and I know exactly what is happening there. Let me just translate that into banker's terms, and I gather you have some banking experience.

There used to be a rule of thumb that if you had $10,000 of income, you could get a house mortgage for $25,000, let's say, 2½ times your nominal income level. At 17-percent interest, which is the Fannie Mae rate right now the old banker's rules of the amount of after-tax income you should have to cover interest and the other housing expenses mean that in today's market for $10,000 income, you can get a $10,000 mortgage. Now, you don't have to be very astute to see that in that kind of an environment, most of the families, even with two wage earners, do not have enough money to qualify for home loan. Therefore, we see that the small businesses that build homes are in a depression.

So, the first point is that interest rates are, a key to the recovery. We have to bring them down before housing will recover. We already know that auto sales respond when interest rates come down a bit, and, of course, businesses become more viable when they are not spending a large part of their after or before tax profits on interest.

Mr. ROEMER. Where is your optimism?

Mr. DUNCAN. My optimism is the following: The real interest rate is clearly out of line with any historical experience. The problem we have is a problem of expectations. The only way I can explain high real interest rates today is because people expect inflation to come back.

Why is there uncertainty? There is uncertainty for two fundamental reasons. First, the financial community always lags real economic behavior. They lost money on the upswing in interest rates because they were paying more for the capital than they were getting in return. Now, they are in the same boat. They are getting a little cheaper capital. It hasn't dropped very much yet, but it is a little cheaper. Bank profits are increasing right now, but they are waiting for the next ratchet back up and so, therefore, they are not adjusting. Just last week, when interest rates ticked back up, there was an immediate response to the short-term phenomena. What I am suggesting is that the banks and the financial community have lagged real conditions. That is factor No. 1.

Factor No. 2 is the enormous uncertainty that faces the citizen and the businessman in our economy today and, unfortunately, gentlemen, the main source of uncertainty is the lack of knowledge about what the final congressional budget will be.

Mr. LAFALCE. The small business innovation research bill is coming up to the floor this very second. We will recess. Can the three bankruptcy trustees come back at 2 o'clock? Would that be possible? Would you raise your hands, trustees and judge? Can all three of you come back at 2 o'clock? The subcommittee will recess until 2 o'clock. I will excuse Mr. Duncan and Mr. Liebenson.

Mr. DUNCAN. Thank you.

Mr. LAFALCE. Thank you very much. I am sorry for the abruptness, but we have been ordered to the floor.

[Whereupon, at 11:30 a.m., the subcommittee recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Mr. LAFALCE. The subcommittee will come to order.

I do want to, first of all, give my sincerest regrets to you three gentlemen for the delay that we have had to encounter, but it is beyond our control. We had hoped that we would have finished the small business innovation and research bill last night. We didn't and we had no control over today's calendar. I sincerely hope that that has not inconvenienced you and, if it has, I hope you will understand that we simply couldn't avoid it.

Although, we did schedule resuming the session at approximately 2 o'clock, this was the earliest I could get back.

PANEL CONSISTING OF WILLIAM P. WESTPHAL, SR.; DEAN M. GANDY; AND JAMES T. EICHSTAEDT

With that, I would very much like now to hear from U.S. Trustee William Westphal, U.S. Bankruptcy Judge Dean Gandy, and U.S. Trustee James Eichstaedt and, perhaps, in that order. So, Mr. Westphal, you can be first.

At this time I would like to include in the record the entire text of the prepared testimony of these three gentlemen and they may now proceed as they will.

TESTIMONY OF WILLIAM P. WESTPHAL, SR., U.S. TRUSTEE, DISTRICTS OF MINNESOTA, NORTH DAKOTA, AND SOUTH DAKOTA

Mr. WESTPHAL. Thank you, Mr. Chairman. I couldn't help but think as I sat here this morning listening to Professor Altman and your other witnesses that preceded us, it took me back to the time during World War II when I was a young lieutenant in the Marine Corps. I, by coincidence, happened to serve with the late Paul Douglas, who later became a Senator from Illinois. Paul Douglas was a man in his late forties who in a bit of patriotism had enlisted in the Marine Corps, was commissioned and served valiantly in the Marine Corps.

Paul Douglas was both an attorney and an economist and had taught both subjects prior to going into military service. Out in the Pacific, when time allowed, we would sit around at nights, Paul Douglas and I, and we would imbibe whatever was available to imbibe and instead of talking law, we would talk economic theory. He was a most interesting fellow and at my age I was greatly impressed by his accomplishments and by his knowledge of economics.

As a matter of fact, I was almost tempted to switch over to economics after I came back from the war, but instead I continued on with my legal education and I learned virtually nothing about economics and learned a little bit about the law. So, as I appear before you today, I cannot offer anything in the way of economic theory or economic rationalizations concerning this subject the committee has under investigation today. Instead, I can offer you that which is indicated in my prepared statement, which is the characteristics of the bankruptcies that we see out in my three-State area: Minnesota, North Dakota, and South Dakota.

The table that is attached to my statement indicates that the types of bankruptcies that we are seeing, particularly in these chapter 11 areas. The reorganization cases cut across the broad spectrum of economic activity out in that area. We have had, as have other parts of the country, a significant number of construction industry and construction-related bankruptcies.

Also, we have had a large number of farmer-rancher and farm-related bankruptcies. In this particular current fiscal year, our farmer-rancher bankruptcies are up well over 500 percent of what they were in fiscal year 1981. But I perceive something a little bit different, and I will throw it out for whatever help it may be to the committee, and that is this recession has continued now on into its third year, what we are seeing is sort of a ripple effect. In 1979 and on into early 1980, we saw a large number of homebuilders and construction companies that dealt with commercial construction that were seeking relief under chapter 11. Then in 1981 and 1982, we have seen petitions filed by companies that manufacture concrete products, companies that milled specialized timbers, companies that dealt in specialized types of concrete products.

So, you go from sort of a producer level to the wholesaler, so to speak, in these bankruptcies. The bankruptcies of the homebuilder and the general construction companies, they in turn lead to bankruptcies of larger companies who supply a larger number of people in the construction industry.

Similarly, in the agricultural field, we have had, as I indicated, a large number of farmer-rancher bankruptcies. Those sort of come as the first wave and that first wave is continuing, but the breaking wave right behind it is the failure of the implement dealers, the farm supply companies, the seed companies and recently in North Dakota we have had a couple of manufacturers of farm equipment or fabricators of metal parts that go into other farm machinery who have filed bankruptcies.

So, the longer the recession continues, I think some of these future bankruptcies that Professor Altman has predicted, are going to be taking that shape. I think that you are going to have a ripple effect so that the failure, while it starts out at the person immediately in contact with the public, as those businesses fail, then the manufacturer, the wholesaler, will also experience some failure.

I had a chapter 11 case the other day and in those types of cases, Mr. Chairman, one of the first things that is done is to appoint a committee from among the largest unsecured creditors. The purpose of that committee is to represent the interests of all the unsecured creditors and the law allows that committee to hire an attorney, whose fees and expenses are part of the administrative expenses that must be paid by the debtor.

But in any event, on this list of 10 largest unsecured creditors that was filed in that particular case, there were three entities that themselves were in chapter 11, in one of the three courts in the area that I supervise. So, that is some further evidence of the fact that you have this ripple effect in this business failure problem. You get companies that are on everybody's list of creditors and if they get left holding the bag, or too much of it, that impairs their own cash flow and the first thing you know, they are seeking relief in the bankruptcy court.

Now, you have other witnesses here today. I don't want to prolong my statement here and I now yield to the other gentlemen.

[Mr. Westphal's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM P. WESTPHAL, SR., U.S. TRUSTEE, DISTRICTS OF MINNESOTA, NORTH DAKOTA, AND SOUTH DAKOTA

Mr. Chairman and Members of the Subcommittee: I am the United States Trustee for the Trustee District which encompasses the three-state area of Minnesota, North and South Dakota. I maintain an office at Minneapolis, Minnesota and since October 1, 1979 I have been supervising the administration (but not the adjudication) of bankruptcy cases in these three states.

I appear here today at the invitation of the Committee to furnish information concerning the incidence of Chapter 11 bankruptcy cases in my area of the country and to express my personal opinion as to the primary causes of the recent increase in these types of bankruptcy cases.

The United States Trustee Program was created as a five-year pilot program by the Revised Bankruptcy Act passed by the 95th Congress (Public Law 95-598) and became effective October 1, 1979 in ten separate pilot districts, of which my three-state area is one district.

Business reorganization cases have increased significantly over the past four years in my area as shown by this table:

Chapter 11 filings (Minnesota, North Dakota, and South Dakota)

Fiscal year:	*Total filings*
1979[1]	66
1980[2]	104
1981[2]	154
1982 (8 months)[2]	200

[1] Source: Admin. Off. U.S. Courts Annual Report, table F-2, year ending June 30, 1979.
[2] Source: U.S. Trustee Records, Minneapolis, Minn., for fiscal years ending Sept. 30, 1980 and 1981.

In my letter of March 12, 1982 to Chairman LaFalce, I said: The two primary causes for the increase in bankruptcies generally, as well as for small businesses in particular, are the extremely high interest rates and the length of the current recession.

Let me cite two examples bearing on my contention that these are the two primary causes of failures. I have had cases where a home builder has had to pay as much as seven points above a prime rate of 18 or 19 percent in order to obtain a construction loan. Just yesterday a restaurant owner in South Dakota, who filed a reorganization petition in bankruptcy court a year ago, was in my office and he stated that a year ago he expected an upturn in the general economic picture, but instead it had turned even more downward in the past year.

While it is generally believed that 'mismanagement' is a large factor in the failure of small businesses, based on testimony I have heard in Chapter 11 cases involving various small businesses over the past 2½ years, it is my impression that bad judgment, improper bookkeeping, etc. are a causative factor in only about 10 percent of the cases. The incidence of bankruptcies has increased particularly for small businesses in the construction industry and for concerns related to the automobile industry, such as automobile dealerships, and parts and service businesses. These two areas of economic activity were particularly hard hit during the period of October 1, 1979 to September 30, 1981. For the fiscal year ending September 30, 1981, 13.6 percent of the Chapter 11 cases in this three-state area of Minnesota, South Dakota and North Dakota were filed by construction related businesses. Many of these debtors testified that the high interest rates had all but completely extinguished any new activity in either residential or commercial construction.

Currently, we are experiencing a dramatic increase in Chapter 11 petitions by farmers and ranchers. In the last fiscal year we had a total of 19 reorganization cases or 12.3 percent filed by farmers or ranchers. Since October 1, 1981 and through March 11, 1982, we have had 43 such cases for a 226-percent increase with more than 6 months remaining in this fiscal year. The Minneapolis Tribune of March 11, 1982 reported that the Farmers Home Administration Office in Minnesota had stated that out of 16,068 farm loans outstanding, 7,885 were delinquent. As to farmers, many (but not all) had experienced dry growing conditions or hail in the 1979 and 1980 crop seasons. In 1981 most had good crops with average or above normal yields, but the market price for their crops had fallen so low that their cash receipts from a good crop were insufficient to put them back on their feet after the dry year losses. Yet each believed that with normal growing conditions and an increase in market prices, they would be able to prepare a plan for paying off their creditors, provided they could get an operating loan to put in the 1982 crop.

In March 1982 when I wrote that letter, approximately 110 new Chapter 11 cases had been filed since the start of the fiscal year on October 1, 1981, and of that number, 43 were filed by farmer/ranchers as stated in my letter. As of June 11, 1982, an additional 90 Chapter 11 cases had been filed for a total of 200 cases in slightly less than three quarters of the current fiscal year.

I have prepared the following table showing the incidence of Chapter 11 filings by types of businesses and comparing fiscal year 1981 and fiscal year 1982 (8 months) statistics:

Three-State Breakdown—Chapter 11 Filings By Category of Business

[Fiscal years 1981 and 1982 (8 months)]

State	Farmer/ rancher	Service and supply	Construction industry	Auto related	Manufacturer	Real estate	Trucking industry	Miscellaneous	Total
Minnesota:									
1982	30	28	9	2	14	8	10	14	115

Three-State Breakdown—Chapter 11 Filings By Category of Business—Continued

[Fiscal years 1981 and 1982 (8 months)]

State	Farmer/ rancher	Service and supply	Construction industry	Auto related	Manufacturer	Real estate	Trucking industry	Miscellaneous	Total
1981	6	42	10	6	23	9	3	9	108
North Dakota:									
1982	14	12	1		3			1	31
1981	4	1	2		2	2		3	13
South Dakota:									
1982	37	7	1	1	1	3	2	2	54
1981	9	8	3	2		3	2	6	33
Total 1982	81	47	11	3	18	11	12	17	200
Percent 1982	40.5	23.5	5.5	1.5	9	5.5	6	8.5	
Total 1981	19	51	15	8	24	14	5	18	
Percent 1981	12.3	33.1	9.7	5.2	15.7	9.1	3.2	11.7	

In Fiscal Year 1981 a total of 5,518 Chapter 7 liquidation cases were filed and in the first 8 months of Fiscal Year 1982 new Chapter 7 filings total 3,681. I am unable to furnish the Committee with a breakdown by types of business. However, the Administrative Office of United States Courts, which keeps detailed statistical records for fiscal years commencing July 1st and ending June 30th of each year, has reported that during the twelve months ending June 30, 1981 there were a total of 1,415 Chapter 7 cases filed by business in my three state area. No comparable figures for Fiscal Year 1980 available since that period included the date when the Revised Bankruptcy Act became effective and the Administrative Office's statistics were prepared for only a nine-month period. The Administrative Office's statistics for Fiscal Year 1982 (ending June 30, 1982) will not be available for several months.

Thank you, Mr. Chairman, for inviting me to present this information. I would be pleased to answer any questions from you or members of the Subcommittee.

Mr. LAFALCE. Mr. Westphal, can you give us any more examples of the types of situations we are talking about?

Mr. WESTPHAL. Well, we had a first meeting of creditors just the other day up in Fargo, N. Dak., and it was a company that was a metal fabricator. It made parts under a contract that it sold to the Versatile Farm Tractor Co. and it sold fabricated metal parts that went into certain construction equipment. Now, this company was started in 1973 by a young man who was only 20 years old at that time. I can recall these things because this was just June 15 that we had the first meeting of creditors in his case.

Their first year in business they grossed about $175,000. The second year they grossed about $600,000. The third year they were over $1 million and they finally peaked out at about $3 to $4 million level of sales. They employed 40 to 50 people and in Fargo, N. Dak., that is a fairly respectable employer.

When the farm and construction businesses went down, their fabrication for farm equipment and construction equipment manufacturers dropped off. The company officers decided that in order to maintain their cash flow so that they could meet their debt, they decided that they would switch over and try to do fabricating for equipment used in oil fields, oil drilling and that, of course, is a booming business in North Dakota and certain parts of Montana. This was a very natural trade territory, but it also is a very competitive business and they tried to carry out this changeover or switch from one type of activity into another one. They carried that out in 1978, 1979, and 1980. As this period of high interest

rates and the length of the recession deepened, they just a few months ago had to seek relief under chapter 11 in bankruptcy court.

Now, there is a current example of a small business and the problems they have had in this present state of our economy.

Mr. LAFALCE. I am going to have to, at this point, begin to take another recess, a 10-minute recess, 5 minutes for me to go vote and 5 minutes for me to return.

We stand in recess.

[A short recess was taken.]

Mr. LAFALCE. The subcommittee will resume its session and we will now hear from Judge Dean Gandy, the U.S. bankruptcy judge for the northern district of Texas.

TESTIMONY OF DEAN M. GANDY, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF TEXAS, DALLAS, TEX.

Mr. GANDY. Mr. Chairman, on behalf of the bankruptcy judges of this country, I appreciate very much your invitation. I think that everyone is certainly hopeful that some solution can be found to the problems that face small business and we would like to cooperate in every way we can.

I have submitted a written statement and I will not repeat the items that I have covered in that statement, except in a broad, general, extemporaneous style.

As to the reasons for bankruptcy, at least from the perspective of the bench, I would concur with the statements that have been made previously that there are certainly economic reasons, reasons relating to expensive and scarce credit. Also, I have seen the effects of inflation up until recent times being very much a cause in which a contractor will bid a contract at a given price and then before he can complete the project—this is more something that happened in the late seventies and early eighties—before he can complete the project, his bid is out of date and yet he is stuck with it.

Causes such as that, economic causes, are very significant. Management is also definitely a problem, as I have stated in my statement. Because they are such emotionally charged things that loose management policies relating to heavy spending get a lot of play in the bankruptcy courts, the Lear jets and the five cars and the like. Those are rare, but certainly they are symptomatic of loose management policies.

I see also a trend in the operation of the free enterprise system in the bankruptcy arena. For example, I left the oil business in the middle sixties to get into the bankruptcy area because it was obvious that the small oil company had few places to go except into bankruptcy. Then and 1 or 2 years ago, everyone who could raise $10, whether he knew the difference between a pump jack or not, got into the oil business because it was such a prosperous business.

Now, it has ceased to be a prosperous business and we are having a very large increase in the filing of small oil companies with the weak, incompetent management being weeded out and those that have been in the business before the good times being able to stay.

I saw the same thing happen in the computer area in the sixties and early seventies when IBM priced their hardware at a low price

and their software was at a high price. So, there was the ability on the part of many entrepreneurs to compete in the software market. But when IBM changed their policies to make both low, then the small entrepreneur in the software business was again winnowed out, if he didn't adjust. So, I have seen that operate.

I will be happy to answer any questions in reference to the reasons, but one question may be that that which was asked prior witnesses: What is the solution? I have no solution to offer in terms of high interest rates. That is not my field. I know a great deal about bankruptcy law, but I don't know why there are high interest rates and how to change that.

I would, however, offer this thought. In the chapter 11 arena, I see perhaps 1 out of every 30, 40, 50 companies, perhaps 1 out of 75—I don't know—but I see a significant number of companies, small companies, who have had to go into chapter 11 and who cannot secure any credit. You get into a vicious cycle as you approach chapter 11 in which the entrepreneur, the debtor, is spending all of his time talking to his creditors and he cannot devote himself to constructive work and, therefore, he hangs on just a bit longer until he runs out of money. Then he files a chapter 11.

I have seen a small number of companies, which if the pump could be primed could come out of chapter 11 in a successful way. An example: A company I had to close down last week, 54 years in existence. Now, that probably had problems in terms of management because of its age and the management failed to adjust, but new management was installed, projections were made. Those projections were being met right on target, but initially the projections related to losses and because of the losses, I had to shut the company down.

Whereas, if the debtor could have had a $200,000 infusion of money, there could probably have been a salvation of the company. Now, I know that that has to be approached on an enormously conservative basis. I am not saying whether it ought to be a subsidy or not, but there is no one to lend to a chapter 11 debtor. The SBA does not make the loan. The SBA makes it when the company is ready to start off. The bank will not make the loan. No one will lend, obviously, to a chapter 11 debtor and there is a place for good conservative lending in the bankruptcy area and I hope that the committee will explore that.

[Mr. Gandy's prepared statement with attachment follow:]

PREPARED STATEMENT OF DEAN M. GANDY, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF TEXAS, DALLAS, TEX.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
FEDERAL BUILDING—U. S. COURT HOUSE
1100 COMMERCE
DALLAS, TEXAS 75242

DEAN M. GANDY
BANKRUPTCY JUDGE

March 16, 1982

Hon. John J. LaFalce, Chairman
Committee on Small Business
Sub-Committee on General Oversight
2361 Rayburn House Office Bldg.
Washington, DC 20515

Dear Congressman LaFalce:

I did not receive your letter of March 4 until March 12, and hence must answer it immediately in order to get it to you by March 19. I appreciate your giving me this opportunity to comment on my impressions of why small businesses fail. It is a subject that interests me greatly, I have spoken on it several times in the past, and would be glad to supplement this letter after March 19 with more detail if that might later be possible.

In my opinion, the reasons small businesses fail fit generally into two large categories. The first category is economic. Within that general category, I observe the following causes:

1. Imbalance in cash flow. This can result from inadequate capital, combined with expensive and scarce credit. A case I am trying this week involves a company with approximately $5 million a year in gross sales, which has been borrowing money to cover losses to such an extent that the interest charges quoted at 6% over prime are presently equalling $1.2 million each year. Obviously, that company could not bear such a large interest burden, and when the bank called its loan, it had no alternative but to file a Chapter 11, and hope to arrange its finances in an orderly fashion to reduce its debts, and restore a degree of profitability that would cover the debts as stretched out. In the early 70's we experienced a rash of construction bankruptcies, which were all related to the fact that given companies had bid jobs assuming labor and material costs at a fixed level, but inflation accelerated to such an extent that the rise was not anticipated, and what were otherwise profitable contracts, became disasters to the companies involved.

The rapid, unanticipated inflationary increase in construction also wreaked havoc with owners of buildings or restaurants that had commenced a remodeling program. No estimates of costs were ever reliable, and the owners who had projected levels of expenses at one figure, and found that they were being billed at figures 50-100% higher than the projected figure, simply could not weather this unexpected increase.

2. Loose management policies. This condition exists normally when there is easy, bludgeoning growth in a certain industry during a certain period, followed by a recession in that industry to which the business does not quickly adjust. This is related to the third economic cause which I shall mention later, but it is more general. Symptoms of this condition are the apparent "need" for private jet airplanes, management suites, and similar prerequisites. These do not cause the downfall of the business, but are indicative that management is less concerned with costs than may have been the case in the early days of the business. An attrition of discipline occurs, and when the hard times follow the good times, there is not a quick enough elimination of excess payroll, and other costs.

3. Exceptional prosperity in given industries that bring in less competent individuals who cannot adjust to subsequent recessions. An example of this specific cause would be the small oil operators at the present time. Because of the excess profitability in the oil business at the present time, many individuals with little competence in the industry have entered it, and when the slightest problems are encountered, the free enterprise system tends to winnow them out. They have no other alternative but to seek bankruptcy protection. Another example would be the computer industry in the late 60's. At that time, before Japanese competition became significant, the making of money in the software industry was relatively easy. The giant of the industry, I.B.M., had priced its hardware on a competitive level to dominate that market, but had priced its software at a much higher level which permitted successful competition by a multitude of small software computer companies. They could also, by limiting themselves to software, avoid the built-in obsolescence problem that the larger companies experienced. However, by the late 60's and early 70's, I.B.M. changed its pricing policies to be less competitive in the hardware industry, but more

competitive in the software industry, and the smaller software companies who failed to adjust and successfully compete, fell by the wayside. Under this general category, I would also include businesses that fail because of the injection of external factors that no one anticipated, and to which the business cannot successfully adjust. The last cited illustration of the computer business may be involved here. Another example would be the real estate companies owning and specializing in raw land in the early 70's. Dallas and its environs, at that time, experienced a phenomenal growth in the value of raw land, and many sales between all of the various traders in this commodity occurred at this time, with a great deal of profit to all concerned. However, when the Yom Kippur oil embargo hit suddenly, the fact that undeveloped land situated many miles from the city might be affected by transportation problems dawned on the general public, and thus, the value of the raw land plummeted, along with all of the profits that had been earned, leaving many of the owners with large notes, substantial deficiencies in the collateral securing those notes, and no longer a profitable cash flow.

The second general category causing small businesses to file for bankruptcy would be the change in moral thinking in this country in the last few decades. This is an even greater reason to assign for consumer bankruptcies. Businessmen once took bankruptcy only as a last resort. Now, I think they probably resolve a decision in favor of a bankruptcy filing at an earlier point in time than they would in the past. This is not altogether bad since Chapter 11 cases now are, in my opinion, generally more successful than they were in the past when the patient was moribund at the time of filing. Large bankruptcies like Pennsylvania Railroad, W. T. Grant, or Omega-Alpha, with all of their resultant publicity, seem to have encouraged the small businessman to do likewise. The social stigma of bankruptcy is no longer as strong as it once was.

One factor which I do <u>not</u> assign as a reason for the increase in filings is the new Code. On the contrary, because of uncertainty regarding the Code in its early days, I think the change in the law may have depressed the filings beyond what they would have been under the Act. I do think that the fact Bankruptcy Clerk offices and Bankruptcy Courts are handling 300-400% more business than they handled before, with the same number of bankruptcy judges as before, has created an enormous strain on the system. Yet, in spite

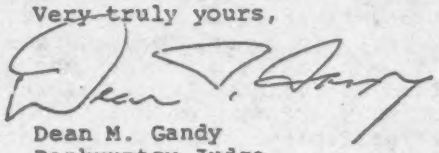
of this strain, I do think the Code is working successfully in solving, with in the judicial framework, many of the debtor/creditor problems that before were not successfully resolved.

To answer specific portions of your letter, as noted above, I think that small oil companies in my area are the types of concern whose numbers are increasing at the present time. Construction companies and land holding companies also continue to file, but, because of the general prosperity in Dallas, the ordinary mercantile company is generally successful.

As to comparing trends in the past decade, and comparing the 1974-75 recession to the current recession, you will note that I have covered specific industries in the above comments. In the Dallas Division of the Northern District of Texas, bankruptcies have consistently increased in spite of general economic prosperity, and I enclose a schedule showing you that increase and comparing the numbers between 1974-75 and 1980-81. As noted above, there were more real estate and construction companies in the early 70's than we now experience.

I hope that the above is helpful. It comes from twelve years experience on the bench, four years general practice of bankruptcy and oil and gas law, and thirteen years in the oil business. Please let me know if I can be of any further help to you.

Very truly yours,



Dean M. Gandy
Bankruptcy Judge

DMG:jh

Enc.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

BUSINESS BANKRUPTCIES FILED UNDER THE ACT (CHAPTERS VII & XI) AND THE CODE (CHAPTERS 7 & 11)

1972	130	
1973	169	
1974	215	
1975	325	
1976	288	
1977	232	
1978	246	
1979	290	
1980	334	
1981	529	
1982	124	as of 3/12/82

1974	215
1975	325
	540

1980	334
1981	529
	863

Mr. LAFALCE. What position does a lender take when he lends to a chapter 11 debtor?

Mr. GANDY. Well, the bankruptcy judge, of course, has the power to get him all manner of rights.

Mr. LAFALCE. Can you get him preference over all the prior creditors?

Mr. GANDY. Yes, but I am not talking about that type of loan. I am talking about a more risky loan, one that would be inferior to existing secured creditors, but he has unsecured creditors. The bankruptcy court can prime all existing loans, but that is rarely done. I am talking about, perhaps, a guaranteed SBA-type loan, ahead of unsecured creditors, but not priming existing secured creditors.

But that would be my only suggestion as to a possible solution within the bankruptcy area and I will be glad to answer any questions you may have.

Mr. LAFALCE. Well, let me just defer questions until we hear from our third witness. I have been calling Judge Gandy judge. Is it customary to call U.S. trustees judge also?

Mr. EICHSTAEDT. No, Mr. Chairman. We are definitely not in the judiciary, nor do we have judicial powers. We are called U.S. trustees and not bankruptcy judges.

Mr. LAFALCE. I would like to clarify that. Since the development of the 1978 or the 1979 bankruptcy law——

Which was the date of passage?

Mr. EICHSTAEDT. It became effective on October 1, 1979, but it was passed by Congress in 1978.

Mr. LAFALCE. The Justice Department is responsible for the trustees. Is that correct?

Mr. EICHSTAEDT. Yes.

Mr. LAFALCE. You are appointed by whom? By the Justice Department?

Mr. EICHSTAEDT. Yes; more specifically by the Attorney General.

Mr. LAFALCE. As opposed to the President.

Mr. EICHSTAEDT. That is correct.

Mr. LAFALCE. Are U.S. bankruptcy judges still appointed by the President?

Mr. GANDY. No. U.S. bankruptcy judges are now appointed by other district judges, but as of April 1, 1984, they will be appointed by the President for 14-year terms.

TESTIMONY OF JAMES T. EICHSTAEDT, U.S. TRUSTEE, CENTRAL DISTRICT OF CALIFORNIA

Mr. EICHSTAEDT. Thank you, Mr. Chairman. I appreciate your invitation to respond to your inquiry by letter, your invitation to prepare a statement and the opportunity to appear before this Subcommittee on General Oversight concerning the causes for the increased number of small business failures.

I will summarize my prepared statement, based on data developed by our staff as set forth in the statement.

The case filings in the central district of California have been rising dramatically. From the date we started our office on October 1, 1979, under the Bankruptcy Code, as contrasted with the Bank-

ruptcy Act, the previous law, the central district experienced cases filed of about 1,000 per month.

This monthly figure rose steadily through 1980 and into 1981 to a monthly filing rate of about 2,000 cases, including chapter 7 liquidation cases, chapter 13 cases, and the chapter 11 reorganization cases.

Now, during 1982, we find that the central district's bankruptcy case filings have risen further, surpassing a monthly filing rate in the aggregate of 3,000 cases. Again, included in this figure, are chapter 11 cases, which recently have represented almost 200 filings per month compared to 20 to 30 per month back in 1979 and part of 1980. We project that chapter 11 filings will soon exceed 200 per month.

Based on the testimony of debtors at meetings of creditors, and our own staff conferences with debtors at the outset of the cases, we have set forth in an appendix, attached to our prepared statement, a description of the chapter 11 cases pending and a description of 100 chapter 7 business asset cases also presently pending. We were able to distinguish fairly precisely the size of the business at the outset of the case and, based upon our analysis of pending cases, virtually all of these cases fall within the definition of small businesses, namely one with 500 or less employees.

In fact, the only two cases, considering the parents and subsidiaries as one case, with more than 500 employees are the *Wickes* and *Sambo's* cases. About 85 percent of pending chapter 11 cases come within a category of businesses with 10 employees or less.

We have also categorized the present caseload of chapter 11 debtors into various types of businesses. Of course, a particular entity may have several lines of business, and in such cases we attempted to choose the primary business.

We find that real estate cases comprise over 62 percent of the present chapter 11 caseload. Further, within this general category we further distinguished real estate cases into either owner/investor filings or contractor/builder cases, and owner/investor real estate cases tend to have few employees. For example, in the case of a debtor owning an apartment building, the debtor may hire outside management or employ a manager or small staff to manage the property.

The next largest category of chapter 11 cases was the retail businesses, followed by manufacturers, and service entities. Within each of the categories for retail and manufacturing entities, we provide two subcategories, one for hard goods entities and another for soft goods entities. With regard to service businesses, we provided subcategories for professional and repair, maintenance, and miscellaneous businesses.

The total pending chapter 11 cases analyzed were 1,289. As indicated in the statement, this figure includes several large business entities which were counted as one case, when actually they were comprised of a number of subsidiaries. So the actual number of pending cases is somewhat larger, by a factor of 25 to 30 cases. Further, we were not able to provide data on some of the recently filed chapter 11 cases.

The categories of manufacturing and retail cases included a wide variety of types of businesses, all with a relatively small number of employees.

Generally, we find that small business debtors have most, if not all of their assets pledged on lines of credit. By way of contrast, several of the large debtors in their prefiling years maintained large unsecured lines of credit.

As Judge Gandy indicated earlier, small businesses have a great deal of difficulty in borrowing both before and after their filing for protection under the code. Their difficulties in borrowing, of course, have been intensified by the prevalent high interest rates and recessionary economy. In turn, these factors have affected adversely the number of confirmations of reorganization plans which we have experienced in our district. We have provided data concerning this situation in the statement.

Getting back to the reasons for small businesses filing under the code, again, we have compiled data based on interviews with and testimony of debtors, together with consideration of other data related to a particular case. We have not limited the number of reasons for filing in our data presented in the appendix, except with the caveat that such reasons be major reasons. Generally speaking, in developing the data related to reasons for filing under the code, we attempted a relatively comprehensive survey of all significant reasons, not merely high interest rates of the recession. Under capitalization, inadequate management and inadequate accounting controls are named in a number of cases as major reasons for filing.

Generally, in the cases involving small businesses, we have noticed that while the debtor may have a fairly good fix on its pricing structure, perhaps because the pricing may have to be competitive, the debtors have trouble in establishing their cost structure. The fundamental question of what the actual cost of the product is, too often goes unanswered.

Besides the reasons given above, there are other categories involving reasons which were not frequently cited.

Mr. Freed suggested that we present information on the age of business debtors. This data is also presented in our statement. But it is limited to businesses under or over 10 years of age. In summary, about 18 percent of chapter 11 cases filed involve older businesses in existence for more than 10 years.

In addition, we selected 100 chapter 7 business cases in liquidation on a random basis, although when I say random, we did not use a true random number sampling. That is, we did not base this on any random number table. There is probably 1 chapter 7 case in 10 which represents a business case. In reviewing the cases we selected from the pending chapter 7 business cases, it was interesting that we did not see any of the real estate owner/investor cases. Rather we saw a significant tilt toward the service industry category followed by the retail and manufacturing industry cases. Beyond this, as we noted in the statement, the cases and data presented represent actual debtors in pending chapter 11 cases. Certainly, there are other matters occurring in the central district which will impact not only the filings under the code, but the economy of the area generally. One such matter which is described in

our statement is the decision on the part of the Fedmart chain to liquidate the chain out of court. In fact, if you were to visit any of their stores, you would find a fairly picked-over liquidation sale still in progress. According to recent newspaper articles, the company has apparently decided to close all its stores and deploy its capital elsewhere. But the immediate impact, as reported, is that some 8,000 employees will likely lose their jobs. We would expect to see some of these people in bankruptcy cases and, of course, the small suppliers and others will be adversely affected by losing such a large customer.

Thank you, Mr. Chairman. This concludes my summary of our statement.

[Mr. Eichstaedt's prepared statement with attachments follows:]

PREPARED STATEMENT OF JAMES T. EICHSTAEDT, U.S. TRUSTEE, CENTRAL DISTRICT OF CALIFORNIA

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I am the United States Trustee for the Central District of California which includes a seven county area including Los Angeles and five other cities among the largest cities in the United States.[1/]

I appear here today before the Subcommittee on General Oversight at the invitation of the Honorable John J. La Falce, Chairman, by letter dated June 8, 1982. More specifically, I will be presenting information concerning the size and types of business which have filed under the Bankruptcy Code in the Central District, I will also be discussing the primary reasons for such filings. This information is based on discussion and/or testimony with debtor(s) as well as information generally collected by the office.

The Central District encompasses an area which has a diverse economy, including businesses ranging from major aerospace and defense companies to numerous small businesses, such as car washes. Despite its general resistance to the recession, in part because it is not tied to a single, major industry, e.g. Detroit, the Central District has experienced a comprehensive and voluminous bankruptcy caseload.

1/ These five cities are in order of population; Long Beach, Anaheim, Santa Ana, Huntington Beach, and Riverside. Source, U.S. News and World Report, February 16, 1981, p. 59.

Further, the number of cases filed under the Bankruptcy Code has been steadily increasing during the past two fiscal years and eight months since the Code's effective date of October 1, 1979.

The following table is based on the number of petitions filed under the Bankruptcy Code for the first two fiscal years, 1980 and 1981, and reflects this large and increasing caseload:[2/]

	FY 1980	FY 1981	Percentage Increase
Chapter 7	16,421	19,026	15.8
Chapter 11	285	559	96.1
Chapter 13	1,888	4,030	113.5
TOTALS	18,594	23,615	27.0

During the present fiscal year, particularly, during the past four or five months, the case filings have risen dramatically and are above the historically high levels achieved in the previous two fiscal years. This district now has the distinction of having the highest filings in all three chapters. For example, during January through April of 1982, the petitions filed are as follows:[2/]

	1982			
	January	February	March	April
Chapter 7	1297	1558	1991	1722
Chapter 11	101	127	186	184
Chapter 13	765	823	934	845
TOTALS	2163	2508	3111	2751

[2/] This data represents a summary of the monthly filings provided in Appendix I. Also, charts depicting the monthly filings are presented in Appendices II and III.

The significantly increasing filings are apparent. Should this trend continue the previously high figures will soon be eclipsed.

Businesses, including sole proprietorships, partnerships, and corporations generally may file Chapter 7, 11 or 13, except that Chapter 13 relief is available only to individuals.[3] Accordingly, Chapter 13, when other filing requisites are considered[4], offers relief to a limited number of businesses, i.e. "mom and pop" establishments.

Chapter 11 provides businesses an opportunity to reorganize rather than liquidate under Chapter 7. Generally, Chapter 11 is preferred simply to keep the business operating and to seek to rehabilitate the business through a consensual agreement with its creditors and perhaps its equity owners.

Chapter 11 filings have increased substantially since the Code became effective on October 1, 1979. This increase which is also continuing, is depicted by a chart in Appendix III, as well as by the monthly totals in Appendix I.

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[3] 11 U.S.C. § 109(e); also Chapter 11 relief is not available to domestic banks and insurance companies and the like and foreign banks and insurance companies doing business in the United States. 11 U.S.C. § 109(d).

[4] Petitioner(s) must have less than $100,000 unsecured debt, and less than $350,000 in secured, non contingent and liquidated debts.

Chapter 11 Cases

We have analyzed our current Chapter 11 caseload from the standpoint of certain characteristics present in these pending cases. The results of our analysis are contained in the table in Appendix IV and are discussed next.

Size of Business

In terms of the number of employees in the business, the businesses having 0-10 employees comprise some 84.7% of the Chapter 11 caseload. In the next size category, 11-50 employees, there are 12.8% of these cases. Only 2.3% of these cases have 51 or more employees. The largest two pending cases, Wickes and Sambos [5/] have total staffs aggregating approximately 50,000 employees.

[5/] In re Wickes Companies, Inc., a Delaware Corporation; The Wickes Corporation, a Delaware Corporation; Gamble-Skogmo, Inc., a Delaware Corporation; and affiliates and Debtors. Case Nos. LA 82-06657-WL through LA 82-06665-WL; LA 82-06755-WL; LA 82-06756-WL; LA 82-06933-WL through LA 82-06935-WL; LA 82-07139-WL and LA 82-07144-WL; Also, Sambos Restaurants, Inc., LA 81-155593-CA.

Type of Business

Four general business activities [6] were considered with the following results:

		Numbers of Cases	Percent
1)	Real Estate	805	62.4
2)	Retail	230	17.9
3)	Manufacturing	140	10.9
4)	Services	114	8.8
	TOTALS [7]	1289	100.0

Real Estate

From this table, the most revealing factor is the dominance of real estate cases. Referring to Appendix IV, almost one-half of pending Chapter 11 cases have for their prime activity owner/investor real estate.

While the boom in real estate during the 1970's helped bolster the economy in this region, it has turned out to be a double-edged sword.

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[6] A given business may have several activities in several categories. The business' primary activity was selected for inclusion in this table.

[7] The actual number of pending cases for our office exceed this total, but some are too new to have been analyzed while others are in the process of or recently have been converted to another chapter. Also, related cases in several instances are counted as one business, e.g. the 20 Wickes' subsidiaries are counted here as one business with the parent company.

The higher real estate prices in this area have made real estate more sensitive to the higher financing costs and consequently have made real estate more difficult to obtain, thereby, depressing the real estate market.

Additionally, the higher real estate costs, especially when compared to other areas of the country, act as a deterrent to new businesses expanding or locating into this market. This decrease in business expansion has a ripple effect on the market causing a more pronounced downward movement in the area's economy.

Owners of real estate held for investment are not the only debtors in the real estate category. More homeowners, who generally have been filing under Chapter 7 and 13, are also now turning up among the Chapter 11 filings in increasing numbers.

Further, a phenomenon more particularly found in this region of the country is the troubled "second trust deed" business. This business may take different forms, but it usually involves a mortgage broker service. Typically, it also involves a substantial number of investors in these second trust deeds. When the real estate owner stops making payments on such trust deeds, these investors are usually adversely affected. Such investors may even file their own bankruptcy cases. One such trust deed case is discussed in an article in the Los Angeles Times, dated October 20, 1981 (see

Appendix V), and illustrates this problem area. The Central District of California currently has pending some twenty such cases.

Manufacturing and Retail

The second highest filing category are retailing businesses comprising 17.9% of the cases reviewed. Retailers of soft goods predominate with 13.9% of total filings and the balance of 4.0% related to retailers of hard goods. (See Appendix IV).

Manufacturers follow with an aggregate of 10.9% of pending Chapter 11 cases. Hard goods manufacturers represented 6.6% of manufacturers who filed under Chapter 11, as compared to soft goods manufacturers which comprise 4.3% of all pending cases.

These are virtually all small businesses; again, 84.7% of the 1289 pending cases reviewed[8/] had ten or less employees. Indeed only 0.1% of these cases represented businesses with more than 500 employees, and would not be considered a small business under the definition used by the Small Business Administration.

Retail and manufacturing cases are of too wide a variety to describe here in detail. Generally, the small businesses

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8/ As stated in footnote 6, as well as in footnote 1 in Appendix IV, this figure, in terms of total cases, is actually higher because several of the larger cases, with multiple subsidiaries, are counted here as one case and one business.

suffer from undercapitalization and are more subject to higher financing costs then are the larger businesses. Further, unlike the large cases such as Sambos and Wickes which have large balances of unsecured debt, the small businesses often have their entire asset base pledged against credit lines or loans.

As interest rates rose and have persisted at high levels, small companies have found that their earnings and asset base have been absorbed by debt repayments. Additionally, small companies commonly realize smaller margins on their sales, whether sales represented retail, wholesale or manufactured goods, and their capital bases are more quickly eroded than larger companies. Accordingly, they succumb more quickly to recessionary or high interest pressures and resort sooner to a bankruptcy case. Further, these same characteristics make such small businesses more difficult to reorganize successfully under Chapter 11.

This latter observation appears to be borne out by the small number of cases in which a plan of reorganization[9/] has been confirmed. Of the total Chapter 11 cases filed under the Bankruptcy Code, (See Appendix I), only 47 cases have had plans confirmed to date.

9/ Although a plan of reorganization should be consummated before an assessment of the success of the case may be made, confirmation of a plan by the Court generally reflects that the necessary consensual agreement discussed above has been reached. On the other hand, this is not to say that plans of reorganization may not be filed and confirmed in some of the pending cases.

Again, whereas large companies with sufficient resources often may realize market potential through aggressive advertising and the like, small business often must rely on the "trickle down" business from larger entities.

A small supplier may seek large customers, but this may result in a double edged sword. The initial benefits of landing a large customer necessarily may lead to a degree of dependence on such large customers. If, as now, the large customer cuts back orders, either because of specific internal problems of the customers or because of general reductions resulting from the recession, the supplier may be severely impacted. For example, an awning company recently filed a Chapter 11 case after a major customer asked for and received major concersions in a supply agreement. The concessions basically revolved around the supplier keeping merchandise it intended to ship to the customer. The inability to turn over such merchandise turned a potential profit into further carrying costs at high interest rates.

Service Businesses

A relatively minor number of professional organizations have filed under Chapter 11, namely 26 or 2.0% of total cases filed under Chapter 11. The larger category of other service organizations include a variety of businesses such as a security guard company, a mortuary and a radiator repair shop. In total, service businesses represented 8.8% of Chapter 11 cases, as reflected in Appendix IV.

Reasons for filing

Appendix IV also indicates the reasons for filing based upon discussions with debtors and parties in the case, testimony of debtor(s) and others at creditor meetings and also information in our files. Of course, there are many cases where there is more than one significant reason for the filing. Consequently, the number of reasons exceeds the number of cases presented.

As is apparent from Appendix IV, almost one-half of the reasons for filing relate to the present recession and/or the persistent high interest rates. As may be expected, this reason is closely related to the large number of real estate cases. But this factor also relates to many other types of cases; indeed the recession and/or high interest rates appear as a factor in almost 80% of all cases included in Appendix IV.

Undercapitalization is the leading specific reason given for Code filings, inadequate management and inadequate accounting controls closely follow. These three reasons were the significant factors in many of the case filings. Often they appeared in combination with each other. In other words, where there were inadequate accounting controls, inadequate management likely was also a significant factor.

Of considerably less importance as factors were reasons associated with litigation, strikes, or general employee discord and natural disasters, e.g. a flood.

Age of Business

While many cases involve fairly new businesses, including a high portion of real estate cases, 17.8% of the cases involve businesses which were established more than ten years ago. Even old established businesses may be found among pending cases, e.g. firms 30-40 years old. They appear to have succumbed to a combination of shrinking sales and high finance costs, among other factors. For example, a family-held cabinet-making business, capitalized at over one million dollars, filed under the Code after 35-40 years in business.

Chapter 7 Cases

Considering the Chapter 7 liquidation cases, (see Appendix I), approximately ten percent involved some business activity.[10/] Considerably fewer cases generally, including these business cases, turn out to have assets which may be distributed to creditors.

10/ The Annual Report of the Director for 1981, prepared by the Administrative Office of United States Courts, reported for the year ended June 30, 1981, that 2,711 business cases were filed in the Central District. Of this number, 2,113 were Chapter 7 businesses cases. Referring to Appendix I, 19,303 Chapter 7 cases were filed during this period.

In a survey made of one hundred Chapter 7 asset business cases now pending in the Central District, the following table depicts the types of business activities these debtors conducted prior to filing under the Code:

Type of Business	Number of Cases
Real Estate	
--owner/investor	-
--contractor/builder	12
Manufacturing	
--hard goods	18
--soft goods	6
Retail	
--hard goods	23
--soft goods	11
Service--professions	12
--repair/maint./other	18
TOTAL SURVEYED	100

Notably, no owner-investor real estate business cases were found in this sample. This may be explained by the desire of such owners to attempt to realize on their equity (or perceived equity) in their real estate in the context of a Chapter 11 case rather than a Chapter 7 case. If such an effort to sell and/or reorganize the entity

fails, the real estate may be taken back by the lender, resulting in a dismissal of the case rather than a Chapter 7 liquidation by a trustee.

Also, service businesses appear considerably more frequently than in the Chapter 11 cases. This occurs because there are few assets to conserve or the person may simply move on to another activity rather than attempt a reorganization.

Other

Of course, many businesses do not resort to filing under the Bankruptcy Code for relief; they may reorganize outside a bankruptcy case or they may dissolve the business without filing a bankruptcy case. Yet those businesses which dissolve may create as significant an upheaval in the business region as if a bankruptcy case were filed. For example, recently a major retailer determined to close 46 general merchandise stores, resulting in some 8,000 employees being discharged. Clearly, such a decision will have a significant impact on the economy of the region with the probable result of greater personal and/or business failures.

In Conclusion

Thank you, Mr. Chairman, for inviting me to present this information. I would be pleased to answer any questions from you or other members of the Subcommittee.

APPENDIX I

MONTHLY CASE FILINGS UNDER THE BANKRUPTCY CODE IN THE CENTRAL DISTRICT OF CALIFORNIA

Fiscal Year - 1980:

	7	11	13	MONTHLY TOTALS
October 1979	1122	25	106	1253
November 1979	1150	14	131	1295
December 1979	1114	13	124	1251
January 1980	1065	10	151	1226
February 1980	1110	17	143	1270
March 1980	1331	22	148	1501
April 1980	1420	30	148	1598
May 1980	1502	26	197	1725
June 1980	1573	34	182	1789
July 1980	1708	36	164	1908
August 1980	1713	34	202	1949
September 1980	1613	24	192	1829
FY TOTALS	16,421	285	1,888	18,594

APPENDIX I (Cont'd)

MONTHLY CASE FILINGS UNDER THE BANKRUPTCY CODE IN THE CENTRAL DISTRICT OF CALIFORNIA

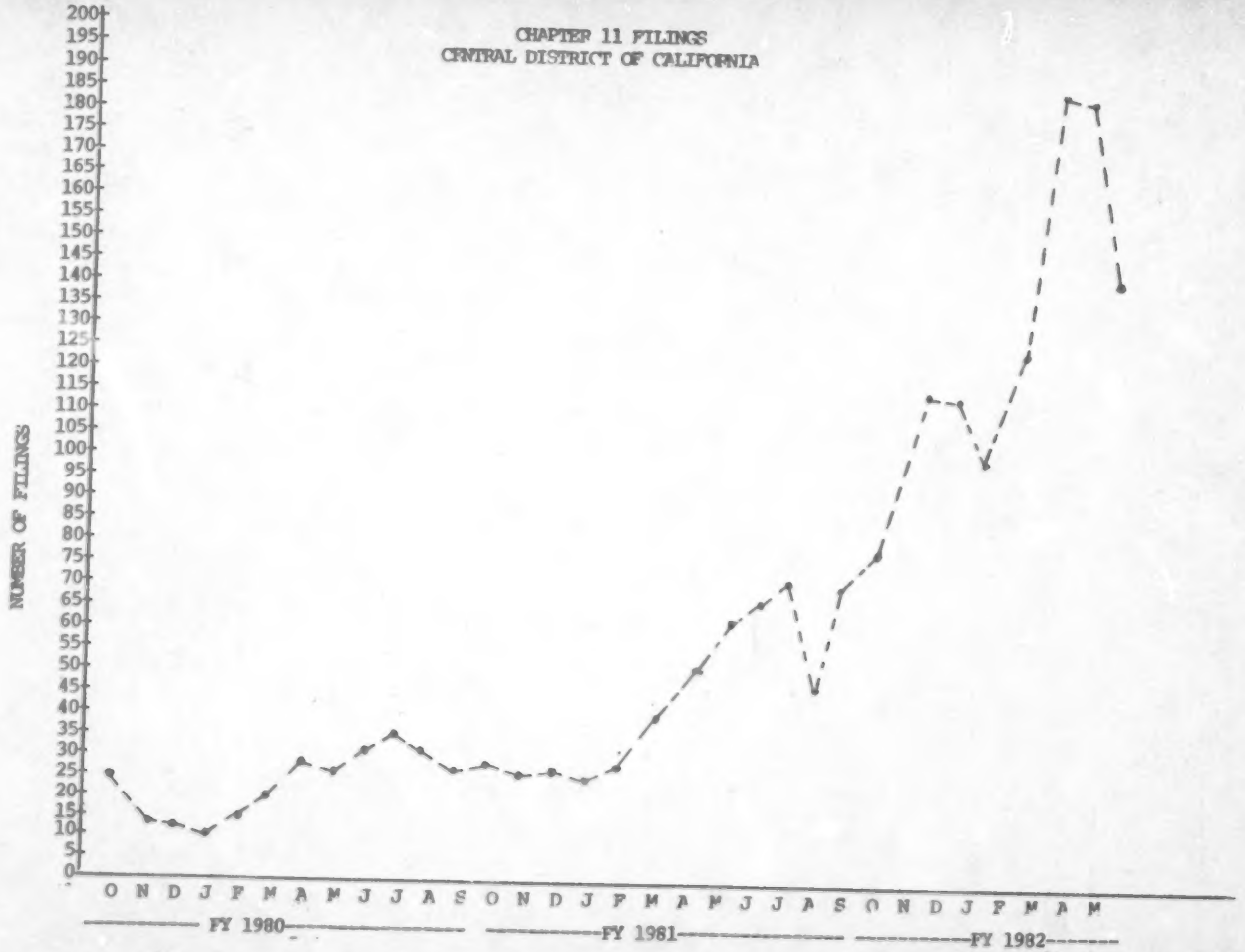
Fiscal Year - 1981:				
October 1980	1770	28	185	1983
November 1980	1452	25	189	1666
December 1980	1498	28	211	1737
January 1981	1398	25	262	1685
February 1981	1502	30	266	1798
March 1981	1742	43	326	2111
April 1981	1814	54	346	2214
May 1981	1506	63	328	1897
June 1981	1587	68	392	2047
July 1981	1732	74	484	2290
August 1981	1497	49	473	2019
September 1981	1528	72	568	2168
FY TOTALS	19,026	559	4,030	23,615

APPENDIX I (Cont'd)

MONTHLY CASE FILINGS UNDER THE BANKRUPTCY CODE IN THE CENTRAL DISTRICT OF CALIFORNIA

Fiscal Year - 1982:				
October 1981	1646	80	705	2431
November 1981	1379	115	683	2177
December 1981	1765	115	890	2770
January 1982	1297	101	765	2163
February 1982	1558	127	823	2508
March 1982	1991	186	934	3111
April 1982	1722	184	845	2751
May 1982	-	140	-	-

BANKRUPTCY CODE PETITIONS FILED
CENTRAL DISTRICT OF CALIFORNIA
NUMBER OF PETITIONS
3100
3050
3000
2950
2900
2850
2800
2750
2700
2650
2600
2550
2500
2450
2400
2350
2300
2250
2200
2150
2100
2050
2000
1900
1850
1800
1700
1650
1600
1550
1500
1450
1400
1350
1300
1250
1200
O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M
FY 1980
FY 1981
FY 1982


CHAPTER 11 FILINGS
CENTRAL DISTRICT OF CALIFORNIA
NUMBER OF FILINGS
200
195
190
185
180
175
170
165
160
155
150
145
140
135
130
125
120
115
110
105
100
95
90
85
80
75
70
65
60
55
50
45
40
35
30
25
20
15
10
5
0
O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M
FY 1980
FY 1981
FY 1982

98-207 O—82——7

APPENDIX IV

Characteristics of Chapter 11 Cases[1/]
(Based on Present Caseload)
June, 1982

Size of Business:	Number of Cases	Percentages of Totals
Number of Employees:[2/]		
0-10	1092	84.7
11-50	165	12.8
51-500	30	2.3
More than 500	2	0.2
TOTALS	1289	100.0
Type of Business:[3/]		
Real Estate--owner/investor	699	54.2
--contractor/builder	106	8.2
Manufacturing--hard goods	84	6.6
--soft goods	56	4.3
Retail--hard goods	51	4.0
--soft goods	179	13.9
Service--professional	26	2.0
--repair/maint./other	88	6.8
TOTALS	1289	100.0

1/ Cases included above differ from the actual caseload because related cases are included as one business, e.g., Wickes' 20 subsidiares are included for purposes of these categories as one business, and certain cases are in the process of being converted or dismissed or cases may have filed to recently to enable our office to prove the above data.

2/ At the time of the filing of the case.

3/ The businesses are categorized by primary business activity.

APPENDIX IV (Cont'd)

Characteristics of Chapter 11 Cases
(Based on Present Caseload)
June, 1982

Reasons for filing:		
Specific:		
Undercapitalization	402	19.4
Inadequate management	324	15.7
Inadequate accounting controls	204	9.9
Litigation[4/]	106	5.1
Strikes/employee discord	3	0.1
Natural Disaster	1	0.1
General:		
Recession/interest rates	1028	49.7
TOTALS	2068	100.0
Age of Business:		
Under 10 years	1060	82.2
Over 10 years	229	17.8
TOTALS	1289	100.0

4/ A major reason for filing appears to have been to shift litigation matters to the Bankruptcy Court for disposition, e.g. executory contract.

APPENDIX V

BUSINESS

...day, October 30, 1981 Los Angeles Times

Downfall of Newport Equity: Illustrating the Investment Risks in 2nd-Trust Deeds

By MICHAEL A. HILTZIK, Times Staff Writer

Even before the lawyer opened his mouth, Paul Beckley knew what he was going to say.

Beckley, a 59-year-old retiree from Pacific Telephone & Telegraph Co., had sought out the lawyer that August evening at a meeting of the Rotary Club of Laguna Hills. They had talked before, casually, about Beckley's $11,000 investment with Newport Equity Funds Inc., a Newport Beach-based mortgage brokerage.

This time, when the lawyer asked how the investment was making out, Beckley handed him a slate-gray piece of stationery. And when the lawyer said after scanning the page confirmed Beckley's worst fears.

The words were, "You've had it."

Made Investment

Beckley and his wife, Joan, had invested the proceeds from the sale of a Treasury bill with Newport Equity in September, 1980. The company used the money in turn to finance a $180,000 construction loan to an Irvine homebuilder for his Riverside County subdivision. The Beckleys were promised a 15% return at the end of a six-month period.

By the Beckleys' account, there was no reason to question the security of their investment. Newport Equity's pitch had been persistently cheerful; its publicity brochure touted the "safety" of trust deeds as investments and forecast "yields to keep up with inflation." The company possessed 11 years' experience in the mortgage business, its literature said.

As it happened, the Beckleys' only return was that single gray page, an Aug. 25, 1981, letter from Donald M. Sutherland, then Newport Equity's executive director and principal owner. The letter told the investors that Far West Savings & Loan Assn., which as the holder of the first-trust deed on the Riverside property was first among the builder's creditors, had foreclosed the previous day.

As a result of the foreclosure, Sutherland wrote, Beckley and his seven fellow investors in the limited partnership that underwrote the builder's loan were "shut out."

The Beckleys' experience is not unique among Newport Equity's estimated 1,300 investors, although how many actually have lost their stakes is unknown. Of the mortgage brokerage's 1,300 outstanding loans, about 120 are delinquent or in foreclosure. At least 10 to 15 more loans, according to court documents, face foreclosures by holders of earlier mortgages on their borrowers' property.

Faces Bankruptcy

It appears unlikely that the company will survive in its present form. The brokerage has been placed in a court-ordered receivership and faces an involuntary bankruptcy hearing today. The state Department of Corporations also has charged Newport Equity with marketing illegal securities and has ordered the firm to cease soliciting new business.

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Joan and Paul Beckley lost $11,000 when a property they had invested in through Newport Equity went into foreclosure.

Lawrence A. Lawinson, former president of Newport Equity

... "We didn't realize the scope of what we were getting into."

NEWPORT: Illustrating 2nd-Trust Risks

Continued from First Page

In addition, some investors have filed civil lawsuits charging the company with fraud. Its two former officers, Sutherland and Lawrence A. Levinson, the company's founder, and, until May 15, its president, also have traded charges. Sutherland, in a letter to Levinson, alleged unspecified "fraudulent conduct"; Levinson responded in an interview that Sutherland "was not prepared for the immensity of this business."

Court-appointed receiver Milton G. Gordon, whose examination of the company's books is continuing, said late last week that he has found no evidence of fraud or of tampering with investors' accounts.

Documents filed in Orange County Superior Court by the state Department of Real Estate allege that Sutherland, then the company's top officer, turned over Newport Equity's books to its controller on Sept. 11 and abandoned the business. That action, the agency charged, left unprotected about $20 million in clients' investments.

Misunderstood Risks

Interviews and court documents show that many of these investors misunderstood the risks of the trust-deed market, which underwent a period of explosive growth after Proposition 2 eliminated mortgage rate ceilings.

Proposition 2, passed by California voters in 1979, boosted the possible returns on mortgage investments by 5 or 10 percentage points, bringing them into competition with more traditional investments such as Treasury bills. The prospect of dramatically higher yields attracted to the trust-deed market thousands of traditionally conservative investors who were unprepared for the vigilance that such investments require, state authorities say.

California investors like Beckley put a conservatively estimated $2 billion into trust deeds in 1980, these authorities say. The ballooning of the business, combined with a softening in the real estate market, have produced a crisis for dozens of trust-deed brokers handling hundreds of millions of investors' dollars, they add.

"We're seeing the same pattern over and over again," says Deputy Commissioner Steven Gourley of the state Department of Corporations, which has taken administrative actions against 28 firms, including Newport Equity.

"Some take too much money as profit and end up with cash flow problems," Gourley says, "or they've made a lot of bad loans and can't foreclose because the (housing) market's so bad."

Older Investors

The investors fall into a pattern as well, he says. "They're predominantly older people who are sold this investment on the basis of keeping up with inflation."

Many investors are led to believe that their stakes are as secure as conventional bank investments, Gourley adds. "I've seen representations that they were as safe as certificates of deposit. That doesn't just gloss over the risks, it misrepresents them."

State regulators and industry executives agree that trust-deed investments are not risky enough to be considered speculative. But, these observers add, managing a large portfolio, as Newport Equity did, requires considerable care, especially if the loans are subordinate to other mortgages.

Newport Equity, according to court documents and interviews with investors, borrowers, and company executives, suffered from many of the problems afflicting other trust-deed firms which have gotten into financial difficulty.

To remain competitive, for example, the company engaged in the controversial practice known as "advancing," in which a borrower's delinquent payments to investors would be covered, or advanced, by the company. As delinquencies increased during the last year or 18 months, Newport Equity's advance commitments reached as high as $40,000 to $50,000 a month, accordi to Paul DeQuattro, an attorney who is representi Sutherland.

Starting near the end of 1980, some investors say th the company gave them scant warning that property which they had invested faced foreclosure by such s nior lienholders as banks.

Given enough warning, some of these investors s ert, they might have been able to raise enough cash cover the senior lien and ward off foreclosure.

"Their way of doing things changed in the last year or so," said one borrower, a real estate agent who do successfully with the company for eight years—until threatened to foreclose this year on a loan that was, at says, only one month delinquent.

"This time I never even got any notices in the mail- just a phone call giving me two days" to bring the loa current, she says.

In the sluggish real estate market of 1980 and 198 even foreclosing on bad loans became progressively le productive as property became difficult to sell. And a though it had a decade's experience in the mortgag market, Newport Equity discovered that Proposition had entirely changed the rules.

"We didn't realize the scope of what we were gettin into," acknowledges Levinson, who founded the compa ny in 1970.

Blue-Chip Image

Newport Equity always operated out of one of th finest business addresses in Newport Beach, a signal t its customers and clients that it intended to serve blue-chip market.

In fact, the company maintained a blue-chip imag for many years, those familiar with the industry agree "They were probably one of the most thorough loa companies around," says one Newport Beach real estat broker.

But in the months before Proposition 2 removed mortgage rate ceilings, the company was in "dire straits," as Levinson put it in an interview. With the state's usury law clamping a 10% interest-rate ceilin on mortgage loans, the company was having trouble attracting investors.

"Our product wasn't realistic," Levinson says. "We were selling 10% paper when T-bills were at 13%."

By the end of 1979 the company's problems were compounded by its move to 2 Corporate Plaza, a new office complex in Newport Center. The office rent was $14,000 a month and the relocation would require hundreds of thousands of dollars worth of furnishings.

Ester Sutherland and Tamblin C. Smith. The two men were businessmen with considerable financial holdings, according to attorney DeQuattro, and they believed that the passage of Proposition 2 would allow the mortgage lending market to thrive, improving the value of ownership of Newport Equity.

Bailed Out Firm

The pair each put up initial investments of $65,000 to bail out the company, DeQuattro says. Although Sutherland was a real estate broker, he had no interest in managing the company. Management was to be left to Levinson, who signed a three-year contract as president, according to DeQuattro.

But Levinson and Sutherland swiftly came to a disagreement over how the company should be managed, with Levinson seeking to branch out into services such as escrow financing. That expansion, DeQuattro argues now, would have been "ill-timed," and never was undertaken.

Both Smith and Sutherland declined to be interviewed for this story. Smith referred inquiries to Sutherland, who referred them to attorney DeQuattro.

In the months that followed passage of Proposition 2, Newport Equity was writing an average of $1.5 million in new loans every month, earning its income by taking commissions of between 10% and 15% from the borrowers on each loan. The income, Levinson says, was

Los Angeles Times

sufficient to pay off the company's debts.

But mortgage interest rates continued to rise; when they approached 20%, business again turned sour.

For the most part, according to court records, Newport Equity's loans were financed by gathering investors into limited partnerships that would underwrite the loans. The company functioned as a general partner in each case, servicing the loans, making collections and taking care of all paperwork.

The arrangement's intricacy required an elaborate and costly auditing system.

"We really needed to bring in $1.2 million to $1.5 million (monthly) to cover all expenses," Levinson says. In 1981, he says, monthly sales dropped below $1 million and the company was showing a loss.

President Resigned

Levinson says his disagreements with Sutherland (who had earlier bought out Smith's interest) finally resulted in his resigning as president effective May 15.

But DeQuattro says that Levinson's departure came "at a most crucial period" for the company, and was a "total shock" to Sutherland. Levinson made no effort to recruit a new president, Sutherland's lawyer says. When Levinson resigned, "it was just a matter of time before the company closed its doors."

DeQuattro says that Sutherland personally was financing many of the company's commitments to cover, or advance, delinquent loan payments to investors. During a period of three months, the lawyer says, Sutherland lent the company between $60,000 and $70,000.

Unsecured Loans

Then, DeQuattro says, Sutherland learned of the existence of a portfolio of 17 loans, all dated before December, 1979, that appeared to have been unsecured by any property because of "a loss of records, an amazing foul-up, or fraud."

DeQuattro won't be more specific about the nature of the loans. Howard Wollitz, the lawyer for receiver Gordon, said last week that so far he has not found any such portfolio.

In any event, Sutherland was "no longer able in good conscience to apply his personal funds" to aid the company after he discovered the portfolio, DeQuattro says.

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NEWPORT: Second-Trust Deed Risks

Continued from 6th Page

Without Sutherland's money, DeQuattro says, the company was financially insolvent.

On or about Sept. 11, Sutherland drafted a letter of resignation and placed it in the corporate minute book. He also wrote a letter to Levinson, accusing the former president of unspecified "fraudulent conduct" and demanding a cancellation of his original purchase into the company. Levinson declined, although he says he later briefly considered buying back into the firm.

Levinson denies knowledge of any "fraudulent conduct." Levinson says he believes Sutherland made the charge because it would constitute ground to rescind the original deal.

Started Fretting

Newport Equity's internal problems were not lost on many investors and borrowers. Beckley had started fretting about his investment in February, when his bank statement ceased reflecting deposits of interest payments from his borrower. When he called Newport Equity's offices to check up, he says, he was told "not to worry—there's only a small delay."

Beckley says he learned later that his loan had, in fact, been in serious trouble. The borrower was Westhoff Development Co., an Irvine firm building a 22-home development in the Glen Aven section of Riverside.

"Westhoff's problem was that the homes weren't selling," says Robert Roberts, a loan officer for Far West Savings & Loan, which had issued a construction loan of more than $1 million for the project. "It (the problem) was a lot of what all the developments are facing today—general economic conditions and high interest rates."

(The bank, a spokesman says, has been unable to reach Westhoff's officers "for some time." Calls from The Times to the company's offices were taken by an answering service and were not returned.)

Far West foreclosed on Newport Equity on March 4, but Sutherland put up $30,000 to delay a foreclosure sale until Aug. 20. Newport Equity, on its investors' behalf, then took title to the development's 17 unsold homes, which carried an average price of about $95,000. Newport Equity then tried to sell the homes, offering them to the investors themselves. "We need all the help we can get," Sutherland wrote in a letter to the Beckleys.

Sutherland soon asked the investors to contribute pro-rata shares toward another $30,000 to defer the foreclosure sale to September.

On the day he had turned over his $11,000 check to Newport Equity Funds almost a year earlier, Paul Beckley had signed and initialled a document stating that he "understands the merits and risks of an investment in second-trust deeds." But he says now that he was lost in the intricacies of Sutherland's and Far West's business dealings.

When Sutherland's letter came, asking for Beckley's $1,000.00 share of the $30,000 payment, Beckley says, "It never was clear what that was for, so I ignored it."

Sutherland was unable to accumulate the $30,000. Only one home was sold to investors. On Aug. 24, Far West held its foreclosure sale and the Beckleys lost their investment.

"We cried a lot," Jean Beckley says of the day Sutherland's final letter arrived.

The couple both receive Social Security pensions, and Beckley earns a retirement income from Pacific Telephone. They had invested their $11,000 nest egg in an effort to beat inflation and finance a small vacation home Beckley's brother was developing at Lake Tahoe—a refuge from the couple's El Toro mobile home.

Now they have canceled their vacation plans. The Lake Tahoe home will take longer to complete, and finishing it will require breaking into their other resources.

"I was switching out of something with complete security," Beckley says wistfully of his earlier T-bill investment. "That's how I got caught."

Mr. LAFALCE. Thank you very much.

I would like to ask each of you, do you all generally agree that, although there are many reasons that businesses go into bankruptcy and fail, that the primary reason today and perhaps for the past year has been excessively high interest rates?

Mr. WESTPHAL. I agree with that, Mr. Chairman. I think that is the one common thread that runs through 99 percent of the cases that I have seen in my three-State area over the last almost 3 years now. I think in that connection a point made by Professor Altman this morning is important, because I think it ties together the testimony you received from Mr. Duncan, in which he said, as I recall, that Dun & Bradstreet figures indicate that poor management is a factor in about 90 percent of the business failures, poor or inexperienced management.

But Professor Altman made the statement in that connection——

Mr. LAFALCE. A much smaller margin for error.

Mr. WESTPHAL. There is a much smaller margin for error. So, that as we see these cases, we see companies that have been in business for 25, 30, or 40 years. They haven't been the best managed companies. They don't have the best bookkeepers. Their bookkeeping is a little bit short of what would be desired. They are not very good on cost accounting, but as long as what they had to pay on interest out of their cash flow each year wasn't reaching this, I believe, a 40-percent figure shown on one of Professor Altman's statistics, they had enough money. So, their poor management was not a big cause. They went along. They had a reasonable profit margin, a small, family-owned, closely held corporation or something, and they got by. But under these conditions where they have to pay an exceedingly larger amount of their cash in order to floor plan what they have for sale, in order to buy some new equipment that they cannot get long-term debt on, then this margin of error gets reduced to almost nothing and their cash flow becomes insufficient to meet their current needs.

So, I think the continuation of the high interest rates is a precipitating factor in the large increase in filings that I have seen out in my area.

It has particularly been a problem for farmers. We had a whole rash of chapter 11 filings from farmers this spring who were just unable to get an operating loan to put in their 1982 crops.

Mr. LAFALCE. It has been said that the housing industry is in a virtual depression. Farmers, agriculture, is just about in that same state, isn't it?

Mr. WESTPHAL. Yes, it is, and that is a combination of two factors. One is the high interest rate and the other is the depressed market prices for commodities. How you reconcile both of those, I don't know. There was talk earlier this year that we would have another near bumper crop for 1982. Well, that sounds good for all of us who like to eat and everybody in the world who likes to eat, but if you have a bumper crop that might further depress the commodity prices. So, the farmer is up against problems that he can't control and he can't control the interest. He can't control the market price and he has very difficult times, but they are still hanging in there. The reason most of them are filing chapter 11 is

simply so that they could get an operating loan by getting the court to approve what we call the use of cash collateral and just how long that will go, you know that same farmer, if his crop doesn't bring in enough money when sold in the fall or when his cattle are marketed at the end of the year for him to pay back that operating loan with the 18-percent interest that goes with it, as well as paying off on his secured debt and his equipment purchases and he comes down to the 1983 season and he has to put in a new crop and then the judge has to decide whether he can use some additional cash collateral, which is a different type of problem the second year around.

So, this cost of money is a very considerable factor for the farmer. A farmer who has to have a $100,000 operating loan to get him through from planting to harvest is paying 18 percent. There is $18,000 that has to be taken out of his cash proceeds from his crops and applied just to the interest for his operating loan.

Mr. LAFALCE. Is that the type of interest rate you are seeing on the farm loans, 18 percent?

Mr. WESTPHAL. It is right at 16, 17, and 18 percent and that is true, whether he is getting that money from a bank, from a PCA—production credit association—and so forth.

Mr. LAFALCE. What about automobile dealers and floor plans for automobile dealers? What are you seeing there?

Mr. WESTPHAL. They have all had problems. In my particular area, as I recall, we have only had three or four retail dealers that have filed. Other parts of the country, I have heard, have had many more.

Mr. LAFALCE. There are a lot more in our area.

Mr. WESTPHAL. Yes; there are a lot more in other areas than my particular area, where the three that have filed have been in the Minneapolis/St. Paul area where there are a lot more dealers to compete with. You get out in North and South Dakota and western and southern Minnesota, where it is basically an agricultural economy, you don't have that many dealers. A lone dealer in a town can manage to cut down and hang on and get by on a reduced level of sales, but I have had I think one dealer in South Dakota file. But auto dealers have not been a big problem in our particular part of the country.

Mr. LAFALCE. Judge.

Mr. GANDY. As to interest rates being the primary cause, I would not say that. I would say that it is a significant cause, but in thinking about the adjective to use, it is so interrelated. A small oil company really files, the primary reason being because investor funds have dried up and, therefore the runs no longer meet the loans and, therefore the company is in default.

The company to which I alluded, the 54-year-old company, was in the sewing machine selling business. It had enormous loans and was paying 6 percent over prime. So, that was certainly a highly significant contributing factor to its demise, but an equally significant factor was the depression in the sewing machine business itself, the clothing manufacturing business, and the ripple effect that extended to this manufacturer's representative.

So, I would say it is certainly a highly significant factor in the cause of bankruptcy, but I wouldn't call it the primary cause.

Mr. LAFALCE. Mr. Eichstaedt.

Mr. EICHSTAEDT. Mr. Chairman, generally I agree with Judge Gandy. The high interest rates have been a highly significant cause for filings. As you may note in our prepared statement, we did not differentiate between high interest rates and the recession as a reason for filing. As you can see from our data, the two factors together represent the primary cause for filings.

Also, our data, including matters such as the second-trust deed problem area, reveals the high concentration of cases which involve real estate. The real estate industry, of course, is highly sensitive to interest rates. With the recession added, real estate has become a particularly depressed, hard-hit area of the economy in this district. Further, as described in the article appended to our statement, the problems of the trust deed entities are troublesome enough, but many investors have invested their hard-earned savings into such programs only to find that the person responsible for paying the mortgage does not pay, and this places the investor in a difficult posture because he then may not be able to pay the debt service. Accordingly, a ripple effect can be observed.

Overall the investor may be subject to a double whammy in that they were using the interest, perhaps, to offset a high rate of interest on a residential mortgage. So, without income from the trust deed they may not be able to meet their obligations on their residence and they may lose both their investment and their home.

Mr. LAFALCE. Let me ask the three of you this: I am a member of not only the Small Business Committee, but of the Banking Committee and I am inundated with requests from lenders to cosponsor legislation, which might greatly alter the Bankruptcy Code. The argument that has been used by the proponents of these changes is that it is the Bankruptcy Code that is, if not principally, in large part responsible for the tremendous increase in bankruptcy filings, if not for business bankruptcies, certainly, they argue, for personal bankruptcies.

While I am sure that the bankruptcy changes that we enacted into law in 1978 had some impact, I suspect that they are more modest than most people think and I suspect that the Draconian changes that they would effectuate are they are trying to make a scapegoat of the law for some other problems that exist in order to get those changes through at this time, but I could be wrong.

I suspect that if there are problems with the law, it is probably more with the implementation of it by judges or trustees than with the law itself, but I am not sure. I am not an expert in any way on bankruptcy law, but you are and I would appreciate your advice and counsel.

Mr. WESTPHAL. Well, Mr. Chairman, against a contention that the new bankruptcy law that came into effect October 1, 1979, was too liberal, and that that was the reason why a large number of bankruptcy cases or a larger number of bankruptcy cases have been filed, I don't believe that is true and I can cite some pretty good evidence. That law, while it contained for the first time a so-called set of Federal exemptions, gave to every State the option that particular State legislature could pass a law which says that the Federal exemptions shall not apply in that State.

In my three-State area, both North Dakota and South Dakota Legislatures passed such a law and they opted out so that the Federal exemptions, which are alleged to be too liberal, do not apply at all in North Dakota and South Dakota. Nevertheless, if your counsel will look at the statistics for the number of bankruptcy filings in North Dakota and South Dakota for the years subsequent to the effective date of this act, they will find that they have increased dramatically, despite the fact that there were no Federal exemptions there at all.

Mr. LAFALCE. Is it only the Federal exemptions that they charge are the liberal, permissive provisions of the new code? Are there other provisions, too?

Mr. WESTPHAL. I will yield to Dean Gandy on that.

Mr. GANDY. I have testified on this before other committees, Mr. Chairman. I think you have to draw a distinction between consumer and business and I think the contacts being made with you primarily relate to the change in the consumer laws. The change desired to be accomplished is basically to have a threshold test in which if a debtor is capable of——

Mr. LAFALCE. What law applies to a sole proprietor unincorporated?

Mr. GANDY. Well, that would be if he sought straight bankruptcy, in other words, liquidation, rather than rehabilitation, that would be chapter 7 and that would apply both to businesses and nonbusiness cases. But what we normally talk about as a business case is a chapter 11 case in which the objective of the proceeding is to save the business to realize more than either to save the business or to realize more than——

Mr. LAFALCE. What would be the closest equivalent we had to a chapter 11 proceeding prior to October 11, 1979?

Mr. GANDY. Well, Chapter XI, probably, but chapter 11 under the code, Arabic 11, is an amalgamation of Roman numerals X and XI under the act. So, it is a combination and certainly it can be improved, like most laws. But the principal commotion, I believe, relates to consumer cases and the desire to change the chapter 7 law to make chapter 7 eligible only for those debtors who cannot pay anything in the future.

If a debtor can be shown to be able to pay a reasonable portion of his future income, then he cannot file chapter 7.

Mr. LAFALCE. We have never had that in the whole history of the U.S. bankruptcy laws.

Mr. GANDY. No. Nor for that matter since the Queen Anne statute in 1704, nor for that matter going back to Rome.

Mr. LAFALCE. That is going back pretty good.

Mr. GANDY. That is the argument. Now, the response to that is, one, what is reasonable income. To determine reasonable income one has to know what is a reasonable expense. Am I incurring a reasonable expense when I drive a 1982 car or should I ride the bus? What is a reasonable expense for houses? How do you determine reasonable future income? I think I shall quit if that law passes because I don't know how you would go about determining future reasonable impact. But I think you have hinted at——

Mr. LAFALCE. How would you determine future reasonable income for a Congressman who is up for reelection every——

Mr. GANDY. That is right. Well, you might have that problem, Mr. Chairman.

Mr. LAFALCE. Never.

Mr. GANDY. But you put your finger on another good point. There are no significant changes between consumer straight bankruptcy under the act and consumer straight bankruptcy under the code. The only changes are the following: One, the addition of Federal exemptions——

Mr. LAFALCE. What is the difference between the act and the code?

Mr. GANDY. All right. The act means the 1898 act which was in effect through 1978 has changed. When we use the term "code," we refer to the present law, the one being attacked.

Mr. LAFALCE. Is this just a common way of speaking or is this by law?

Mr. GANDY. No. It is called a code.

Mr. LAFALCE. It was called the Bankruptcy Code before 1978.

Mr. GANDY. But it was not called a code. It was called an act.

Mr. LAFALCE. Didn't a lot of people talk about the Bankruptcy Code?

Mr. GANDY. Probably. But in any event, when we speak of an act, we are referring to the 1898 act. The code is the present law.

There were no significant additions under the code to a debtor's rights, except Federal exemptions and in more than 30 States those exemptions are out. These States have opted out. So, they are no longer effective.

Mr. LAFALCE. Thirty States?

Mr. GANDY. Yes. More than 30. I have forgotten the final count, but a large number of States have already opted out.

Mr. LAFALCE. Do you think this is a growing tendency? Most States will do it?

Mr. GANDY. Well, California and Texas already have State exemptions that exceed the Federal exemptions.

Mr. LAFALCE. That exceed them.

Mr. GANDY. And so they don't have to opt out. So, yes, it is a growing trend——

Mr. LAFALCE. I hate to ask this question, but do you know what the status of the law is in New York?

Mr. GANDY. I do not know the status of the law in New York. No, I don't.

Mr. LAFALCE. Just curious.

Mr. GANDY. Another change was 522(f), which provides that if you want to lend me money on my sofa, a consumer item, that loan is invalid, unless you sold me the sofa. Nonpurchase money liens are, in other words, invalid, the argument being that the finance company really didn't lend money on the furniture. It was just a device to collect the debt, that the furniture was not worth anything. That was an addition.

Other than those two changes, there is no difference between the rights under the act and under the code, so the institution of the code alone would not explain the increase.

Mr. LAFALCE. Mr. Eichstaedt.

Mr. EICHSTAEDT. Mr. Chairman, I think Mr. Gandy has covered the basic provisions of this proposal. Speaking for myself, I have

several questions. One, how would you judicially administer this threshold test? I can foresee potentially extensive testimony on the question of what the future earnings of a person might be. In fact, my recollection about projections in several large business cases is that trustees were reluctant to project a company's earnings beyond 1 year. The issue of what future earnings might be projected at may involve considerable questions of what earnings may be projected as well as what reasonable living expenses might be.

Under the code, debtors only come before the court to attend a discharge hearing. However, if you add a threshhold test as an issue at the outset of the case, judicial time will increase significantly in cases.

Mr. LAFALCE. Don't you have the power to reject a discharge and transfer an individual into a different chapter, where he would just have to have an arrangement of his indebtedness?

Mr. GANDY. No. We have the power to reject the discharge for itemized reasons, such as fraud, false financial statement, such as that. But we have no power involuntarily to transfer from chapter 7 to chapter 13, say.

Mr. LAFALCE. Well, can't you persuade them to transfer it voluntarily by the force of the discharge, I mean, by the force of the rejection of the petition?

Mr. GANDY. I would not think so because the judge cannot reject a petition. He can reject a discharge for——

Mr. LAFALCE. Well, I should have said that.

Mr. GANDY. Yes, he can refuse to grant a discharge, but for itemized, specific reasons.

Mr. LAFALCE. What do you mean by itemized, specific reasons?

Mr. GANDY. Well, actual fraud, because——

Mr. LAFALCE. What about the belief that this company would have the ability to pay or this individual would have the ability to pay it off in the future?

Mr. GANDY. That would not be valid grounds for denying his discharge, no.

Mr. LAFALCE. Do you all agree with that?

Mr. WESTPHAL. The reason I would agree is that Congress, when it adopted the Bankruptcy Act, it specifically stated the grounds or reasons why a judge can refuse to give the debtor a discharge in the bankruptcy case and these are specific things that Congress decided should be in the law and the judge has no power to go beyond that which Congress has said is the specific——

Mr. LAFALCE. Do you think that this might be a possible area for change, clarifying or giving you the power to transfer a case when in your judgment some arrangement of creditors would enable the individual to pay off his indebtedness in the foreseeable future?

Mr. GANDY. Well, I think you would thereby have a threshold test and I think in every instance the creditors would be filing motions seeking to bring that on to cause the bankruptcy judges to make that decision. So, that throws you back in the same problem. What will be his future income?

That has never been a test in the consumer area. Now, he has the right—you understand, he gives up everything that is nonexempt when he files a chapter 7. He has the right to go chapter 13 voluntarily; thereby, he can retain some things if he pays for them

on a basis that the bankruptcy court approves, but he gives up everything in chapter 7 that the State has said should be nonexempt. Well, if he gives up the nonexempt and retains the basic living items that the State says he should retain. In Texas, it is ridiculously too high. In New York, perhaps it is too low. I don't know, but the State decides that.

Now, traditionally, that has always been what has happened in consumer bankruptcies. You give up everything. Then you get your fresh start and start over again.

Mr. EICHSTAEDT. Mr. Chairman, let me point out, as we note in our statement, that there is an apparent trend toward more individuals filing cases under chapter 11 to rehabilitate themselves. Generally, such debtors are trying to retain their equity in certain real estate, but at some point in the case the debtor may realize that they may not be able to reorganize or a creditor may wish to assert that rehabilitation is not viable. Then, a party in the case may file a motion to convert from chapter 11 to chapter 7 or the debtor may consent to such a conversion to effectuate an orderly liquidation.

Mr. LAFALCE. Do you think that there is any inequity in the comparison we make between number of bankruptcies today and number of bankruptcies pre-1979 because of the different grounds for bankruptcy, different chapters, et cetera, different arrangements?

Mr. WESTPHAL. I think the law is basically the same with the exception of these two things that Judge Gandy pointed out. The bankruptcy law is basically the same. It has been simplified somewhat in that you don't have a chapter Roman numeral X. You don't have a chapter Roman number XI and you don't have a chapter Roman number XII. You have one, a chapter 11.

Liquidation bankruptcy is basically the same now as it was, with the exception of the two points that he made. So, I think that a comparison between bankruptcy filings, let's say, in 1975, 1976, 1977 and 1978 and up to October 1, 1979, under the old law, can be made with great validity to the filings under the new law.

Mr. LAFALCE. I take it you two gentlemen would probably basically agree.

Mr. EICHSTAEDT. There is one technical point that I should make with respect to comparing bankruptcy filings under the old and new laws. Under the old law, a husband and wife would normally file two separate cases. Under the code, there is a specific provision providing for a joint case. Therefore when you are comparing filings, you should take into account that the statistics for cases filed under the code as compared with cases filed under the act are understated. The code filings, in terms of the actual number of debtor filing, are 30- to 40-percent higher because of the joint case factor. Again, the code permits a husband and wife to file a joint case and this occurs in about 30 to 40 percent of all chapter 7 cases filed.

Mr. WESTPHAL. What that means is the number of filings since October 1, 1979, as reported to you in our statement are even greater if you are going to compare them to the pre-1979 filings. They may be greater by 30 percent. So, this incidence of bankruptcy at the consumer level, which are mostly chapter 7, are even much greater than our statistics indicate if you are going to compare.

Mr. LAFALCE. To what extent would you attribute this tremendous increase in personal bankruptcies, at least in part, to (*a*) the greater acceptance on the part of the American public to become participants in the litigious society; (*b*), the changes in the code of professional ethics which permits not only advertising, but aggressive pursuit of potential clients?

Mr. WESTPHAL. In my opinion, I think that the fact is today that bankruptcy, the filing of bankruptcy, is not as great a stigma as it was back some years before. It is much more readily done. Nobody feels there is a stigma to it. The truth of the matter is that somebody who has filed bankruptcy can sometimes get easier credit extended to them than somebody who hasn't filed yet, because the fact is he can't file for another 6 years. But, nevertheless, the stigma is not as great in some areas.

Second, I know in my part of the country the fact that there is advertising in classified ads that we will handle your bankruptcy case for such and such a price or get a fresh start, they have various leads, I think that has contributed to making the consumer aware of the fact that bankruptcy laws may give him a chance for a fresh start and I think that, in turn, contributes in part to the increase.

But if the economic conditions weren't there, that required somebody to even consider bankruptcy, the mere fact that some lawyer would do it for you real cheap or promise you a fresh start, you don't need a fresh start if you are not in trouble. That is more or less the bottom line on the advertising. But I think the fact is that in our society, particularly as we are a more mobile society, if you file bankruptcy, you don't have to think that for the rest of your life you are going to live with and do business with the same merchants that got stiffed when you filed bankruptcy. I think that is a factor.

Mr. GANDY. I think it is a very significant factor, the first one that you mentioned in reference to the lack of stigma now. Chapter 11's are being filed at an earlier point in time than they were being filed before and that is really, if the case is going to be worked out, that is really good from the standpoint of bankruptcy.

As to the second point, lawyer advertising is directly related of course again to consumer cases and I have seen a dramatic effect in Dallas on that. You know, on October 1, 1979, when the code became effective, there was no lawyer advertising in Dallas to speak of. There was no increase in code cases, regardless of this argument that the code caused it. There was no increase in code cases. We had something like 15 or 20 chapter 13's.

In June 1980, lawyer advertising hit in Dallas in a very dramatic way, on the television, in the television programs and the like. The Chapter 13's went from 15 to 2,000 in a matter of a few months, all because of lawyer advertising. So, it had nothing to do with the code. It was directly related to this pounding away, come and let us protect you from your creditors.

Mr. EICHSTAEDT. I generally agree with the comments of both Judge Gandy and Mr. Westphal. Lawyer advertising and increasing acceptance of being a debtor under the bankruptcy laws are both highly significant factors in the central district. We are seeing greater acceptance of debtors and debtors-in-possession in a general

sense and we also see very aggressive advertising; lawyers are using more sophisticated methods such as regularly surveying local judgments and liens filed and using such information to pump out letters to those individuals listed offering their services.

We see another phenomenon in the central district. A number of nonlawyer persons and groups have entered the field urging tenants, for example, to obtain the benefits of the automatic stay to avoid for the time being evicted. This has led to the phenomenon generally referred to as the front page petition. In other words, the debtor will file a petition, but will not follow up on the case by filing schedules, a plan, nor any further pursuit of the case. Debtors will, in such cases, merely let the bare petition lie until someone requests that the case be dismissed, whether it be the court, our office, or some other party to the case.

Mr. LAFALCE. What is the legal effect of the front page filing?

Mr. EICHSTAEDT. It is legally effective to stay lawsuits against the debtor. For example, a tenant who is behind on his rent may file a bankruptcy petition rather than attempting to work out a solution with the landlord.

Mr. LAFALCE. How long will there be on the average between the filing of a front page petition and a dismissal of it?

Mr. EICHSTAEDT. It depends on how the case is dealt with. The judge assigned to the case may deal with the issue of the missing schedules or plan fairly quickly, within a matter of a few weeks. But in other cases, it may take some time for the system to deal with a particular case.

Mr. LAFALCE. What is the worst case?

Mr. EICHSTAEDT. Well, a case could continue for months.

Mr. LAFALCE. What is the longest that you are aware of?

Mr. EICHSTAEDT. I can't quote the longest time for such cases without going through our files, but I can tell you that the debtor, even if his case is dismissed, may refile a case. In other words, even if the case is dismissed, it normally would be dismissed without prejudice to refiling a case and this could lead to a debtor immediately refiling a new case upon the dismissal of the old case. In fact, our office has occasionally sought to dismiss one case for failure to prosecute it, only to find that another case already has been filed because the debtor anticipated dismissal and the original case was continued for some reason. Occasionally then, we have found ourselves moving to dismiss two front page petition cases at the same time.

Mr. LAFALCE. It seems as if something ought to be done about that. I am not sure exactly what. It seems to me that the bar association should be able to have some ability to police the type of not only advertising, but client pursuit.

Mr. WESTPHAL. Well, Mr. Chairman, I have spent all my adult life either as a trial attorney or in judicial administration and I think the ingenuity of lawyers to find ways to use the law to aid a client or to circumvent what we might otherwise think of as the due course of justice knows no bounds and neither legislative wisdom nor judicial wisdom can keep pace with that ingenuity of counsel because we in the law have to follow due process——

Mr. LAFALCE. Have we not the continuing responsibility to make it tough for them to do it?

Mr. WESTPHAL. That is right, but——

Mr. LAFALCE. If we don't, once we give them a form of circumventing it and if we don't close that loophole, it becomes more than a loophole.

Mr. WESTPHAL. We are constantly doing it, all of us, but in order to close that loophole, once that case is filed, we then have to follow, in effect, due process. So, that takes 2 weeks, like Mr. Eichstaedt says, or maybe even take 2 or 3 months. Now, we are attuned to it, but we can't eliminate it. I think that is the point of my comment. We cannot eliminate, either as trustees or judges, nor as a legislative body, this effort by somebody to circumvent the law——

Mr. LAFALCE. Is there any way that you as judges and trustees could let that portion of the bankruptcy bar that would engage in such tactics know that it is frowned upon to the point where those lawyers could be persona non grata in your office?

Mr. GANDY. Well, as far as the front page filing is concerned and the duplicate filings, I think that is a California phenomenon. We don't have that in Dallas. We started to have duplicate filings or in other words chapter 13 would be dismissed for some reason and then the debtor would file another one, but we instituted a local rule requiring the debtor, each debtor who filed, to sign a form saying whether or not he had filed a chapter 13 within the past 90 days and that was immediately looked at and dismissed again, given accelerated action. So, we don't have that problem in Dallas.

Mr. LAFALCE. Thank you. Gentlemen, I regret that we are going to have to conclude today's hearing, but I want to thank all three of you. You have been excellent witnesses and very helpful to me and to the subcommittee. Thank you very much.

[Whereupon, at 3:53 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

APPENDIXES

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA

CHAMBERS OF
WILLIAM L. NORTON, JR.
UNITED STATES BANKRUPTCY JUDGE
TELEPHONE (404) 221-6431

532 UNITED STATES COURT
OF APPEALS COURTHOUSE
56 FORSYTH STREET, NW
ATLANTA, GEORGIA 30303

July 19, 1982

RECEIVED

JUL

Mr. John J. LaFalce
Committee on Small Business
Subcommittee on General Oversight
U.S. House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. LaFalce:

In response to your letter of March 3, 1982, the following is submitted. You asked my impressions as to the "causes of bankruptcy by small businesses." You asked my view as to the "primary cause of small business bankruptcies and the types of concerns that are filing liquidations or reorganizations."

I have been a Bankruptcy Judge since December 1971. Prior thereto I was a tax lawyer and my small nine man firm also had represented small businesses. I advised small businesses as to the organization and management of business viz corporations, partnerships, etc. to take advantage of the tax laws and other business considerations. I represented businesses in preparing public stock issues and did a substantial business in pension and profit sharing planning. I represented practically the entire organized poultry industry in Georgia and a far broader georgraphical area. I also was tax counsel for the Georgia Business and Industry Association and Georgia Independent Automobile Dealers Association and about ten or twelve other business trade associations in the southeast. So as a lawyer, I dealt fairly intimately with the problems and concerns of the small business.

Yet, I hesitate to presume to make conclusions from my present vantage point. Since October 1, 1979, the effective date of the new Bankruptcy Code, the Bankruptcy Judge has not presided

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or attended the meeting of creditors of debtors. The Bankruptcy Judge presides only at trials of law suits involving the debtor and creditors, the trustee and creditors and creditors vs creditors in proceedings involving the property of and actions of the debtor. The Bankruptcy Judge is not in as good position to ascertain the reasons for business failures as when the Bankruptcy Judge presided at the meeting of creditors under the prior Act. However, we do learn some facts at the trials generally brought by creditors to get relief from the stay and/or adequate protection. Thus, I will hazard some observations.

Inadequate management for the business being conducted will always be a cause of failure in a substantial percentage of the new small business and in old small businesses which have been inherited or purchased by new owners.

Inadequate capitalization of equity capital will always be a cause of failure of another substantial percentage of new small businesses. Sometimes we see that the growth of sales and production of the business outgrew the equity capital resources and/or the capacity of the management. In other words the needs of equity capital grow with the business and the needs for better, more knowledgeable management grow with the business.

Frequently, as the business grows there is a need for greater accounting and legal advisory help and other needs which the manager fails to realize is desirable until it is too late. Frequently, such entrepreneurial managers are not comfortable with such professional persons - or don't know how to recruit them. Frequently, they do not know the difference in quality of professional persons. That is, they get an incompetent accountant or lawyer and don't know it. Frequently, managers do not realize that wage and hour problems need a wage and hour lawyer, labor problems need a labor lawyer, tax problems need a tax lawyer, etc. That is, some are saddled with their own or attached incompetence for the expanded scale of the business.

Also, there are ~~also~~ always going to be business failures caused by technological changes which render the product or service less attractive to the consumer than previously; and I suppose this can be attributable to lack of foresight of management. Then also there are always going to be business failures based upon location of the business in the community. The facility is too remote. One way street change, or a rerouting of traffic changes shopping patterns. The shopping center has traffic problems or location problems which affect all of the tenants.

Therefore, I will not comment on the above causes, although some of those causes are involved in all of the failures I see.

(1) Textiles: From my area of the country, I see foreign competition frequently as adversely affecting phases of the textile industry. This adversely affects dry goods, panty hose, carpet, blankets, apparel etc.

My view is that most of the managers of this textile industry are progressive, technologically advanced, economically aware, fiscally responsible, managerially sound, but caught in the vortex composed of inflation, foreign competition, and national recession.

We have a number of textile businesses that have either gone on short time or closed or filed for reorganization or liquidation.

(2) Carpet mills: Beginning with that same period the carpet mills of this region were experiencing loss of sales and production. Employees were being terminated and companies were going on short time. Some companies closed. Some companies filed bankruptcies. As you know, a large percentage of carpet goes into new residential units, office parks and office buildings. Thus, reduced residential construction, office, etc, construction, motel construction, immediately affects the carpet industry, as well as the lumber, brick and building supply trade. This trend of such textile depression has been accelerated since 1973 with the greatly increased costs of artifical fibers (petroleum based) and reduced construction starts.

(3) Real Estate Projects: The high cost, acceleratated since the oil embargo of 1973, of construction materials and labor costs, coupled with first the tight money market and then the high interest rates, has decimated the residential construction industry. In 1973-76, this district had a great number of real property reorganizations (Chapter XII) filed for apartment projects and condominiums. Construction cost overruns caused many insolvencies on projects under construction. As you know, many REITs struck out. Sudden energy costs of heating and air conditioning made existing projects (some newly completed) economically infeasible. Utilities were included in the leases then existing in most of the projects. Leases would not permit immediate increases in rent. It took a year or so to convert. Plus, it was expensive to install individual utility meters, etc. Increases

in rental charges created vacancies. Couples moved back to mother and dad, or otherwise combined. The tight money market made condominiums and houses under construction difficult to sell and created foreclosures and bankruptcies for developers and contractors. Now, high interest rates have the same detrimental effect on potential for planned construction and resale of existing residences. The demand for residential housing is apparent but the high cost of construction and high interest rates represent a presently impossible situation. We have real estate agents and real estate companies that are closing the doors on their businesses and even are and unable to pay the mortgage on their own residences and facilities.

Evidence in one case about 1973 or 1974 disclosed that during 1973 for the first year since 1945, Southern Bell Telephone in the Atlanta area, for the first year since 1945, had more requested disconnections of telephone than new telephones installed. There were 25,000 more disconnected telephones than installations. (I never saw such information discussed or taken into consideration by any economist or observer of economic trends. Perhaps such information is considered by economists but I never have seen evidence of it. These facts should have informed us that something was amiss in the economy, even before the oil embargo crisis. The interest rates were rising and inflation was upon us, although not to the even greater extent we have experienced since 1973.) A high official friend of the Telephone Company informed me that a lot of couples were combining residences with relatives. Apparently, the figures were caused by consumer living costs or perhaps by loss of jobs.

(4) Motels-restaurants: I have no way to calculate the effect which high energy costs for housing and transportation, and other direct inflationary costs, have upon consumers reference reduced use of automobiles and vehicles. Obviously, it concentrates purchasing power upon food and lodging and other essentials. However, filings in this court reflect that such reduction of consumer purchasers for housing, transportation, food and lodging, directly affects restaurants, hotels, especially on the outskirts of the metropolitan areas. My court has seen directly the trends in bankruptcies and closings of motels since 1973. The same is true with restaurants and recreational facilities which have either closed or going through reorganization or going through straight bankruptcy.

(5) Vehicles and Transportation: The initial cost and high financing cost of vehicles is obviously hurting consumer purchases of vehicles. Reduced purchasing power of consumers has affected both the vehicle and transportation industry. We see that in the filings of bankruptcies of trucking companies and individuals who own and operate a long-haul truck. (Incidentally, we see sicknesses and accidents of owner-operators of trucks, restaurants, and other small businesses as directly causing insolvencies during the period of recovery.)

(6) We see the reduced consumer resources and reduced use of services re motels, restaurants, transportation, vehicles by the general consumer to be reducing the volume of sales and cash flow below fixed expenses a variety of businesses.

(7) There is some direct relation between business failures and the number of individual Chapter 7 liquidations and individual Chapter 13 wage earner plans which individuals find necessary to file. That is, the discharge of debts and the extension of the period of payment of such debts and the reduction of continued consumer purchases each directly affects the businesses which serve those individuals. Consumer insolvencies (as well as broad-based consumer cut-back of purchases) cause business insolvencies.

The loss of jobs, the short time, reduction of consumer purchases, the bankruptcy or slow pay of consumers, all affect the number of closings of businesses and filings of liquidations and reorganizations of businesses. Then, every time a business closes, those former employees with reduced purchasing power become a continuing sequence of domino effect on other businesses.

The owner-manager of the auto dealership, dress shop, restaurant, office supply, boat shop, building supply, etc., cannot survive when the employees of a dominant employer enterprise or a cumulation of small manufacturers in the community closes or even goes on short time for very long.

Most individuals are living beyond the income derived from unemployment compensation, or beyond short time below 40 hours a week. Many are living on a budget based on not only full time but also overtime. If one spouse loses a job or gets on short time, the family unit budget goes. The inability of such individuals to timely pay their debts directly affect small businesses that sold (or normally sell) merchandise or services to such individuals.

(8) Another factor I see in the inability of small businesses to survive is the fact that some recent corporate and partnership individual loans in the past ten or fifteen years have been tied to some percentage points above prime rate. A construction contract, a restaurant, auto dealership, manufacturer, distributor service enterprise, chicken farm, row crop farm; that debtor cannot pay such volume of interest. I do not know what is the breaking point of the rate of interest upon business enterprises; but I commonly see such businesses unable to pay much above about ten percent. I had testimony of numerous office parks and apartment and condominium developers during 1974-77 that no real property developer could pay more than 14% and survive. We now have such loan contracts keyed to the so-called prime rate which has increased above 18, 19 and 20 percent. That means 22 to 24 percent interest. When construction loans got above 12-14% we found in 1973-76 that developers couldn't stand it. The businesses cannot stand that. Individuals can't stand that. Recently, I had a restaurant that had a SBA loan keyed to 4% above prime, i.e.: totaling 22% for several months. I was shocked, as I frequently am, at the total amount of the bank - SBA loan considering the facility and what my feeble mind considered to be the reasonable prospects for any profits, (let alone carrying that $400,000 debt) at that location.

(9) I do not see incompetency or mismanagement or dishonest actions in individuals or businessmen, which some credit grantors and others ascribe to debtors in the Bankruptcy Court, as being the cause or prevalence in bankruptcies. I see the overwhelming number of individual and business debtors in this court who sincerely and honestly want to pay their debts and have been and are attempting to pay such debts. I see many businesses and persons in my court who I feel: there, but for the grace of God, go I.

(10) Frequently, we see businesses and individuals as having grossly overextended themselves with credit and perhaps the debtor should be criticized for such overextension. However, that to me is a two-way street. We see creditors howling and alleging debtor dishonesty in the extension of the credit. Yet, in the hindsight provided by the evidence, it frequently appears that these consumer loans or other extensions of credit were totally illadvised when made. That is, made under conditions of borrower debt which was too large even as the new loan was made. I see grossly inadequate consumer creditor restraint on granting loans, although creditors argue otherwise. As stated earlier, consumer bankruptcies directly affect business debt recovery and gross sales. The granting of consumer loans or credit by merchants (as in credit cards) in the few months just preceding consumer bankruptcies is constantly the picture seen by Bankruptcy Judges and bankruptcy lawyers. When credit payments get too oppressive, individual bankruptcies ensue and all other prior business creditors suffer.

(11) Many Small Business Administration loans negotiated by private banks are in the same character. Over the years, from the evidence in my court, I have been highly critical of the Small Business Administration in the granting of loans negotiated by banks and negotiated directly by SBA. (The same is true with many farm disaster loans.) The loans ignore credit-worthiness and earnings capacity and frequently are not in the borrower's best interest considering their capacity for management and type of business, location and reasonably calculated sales.

There seems to be little paternelistic overview as to whether any SBA borrower has the business credentials, the potential to succeed at this location, at this time, in this business. There seems to be no follow-up (as I think should be in most SBA loans), i.e.: in loco parentis, of the debtor's management and performance after the loan is consummated. I have seen the SBA loan proceeds and the owner equity capitol exhausted before the enterprise opens its doors. In the hindsight of the evidence before me, it was doomed from the outset and any reasonable loan officer should have recognized it forthwith. The pity is that that individual SBA borrower, frequently a minority individual, lost his own capitol and labor, along with our taxpayers' funds, in an enterprise which the reason of a lender's experience should have known to be hopeless.

(12) Hence, I guess I see loss of consumer purchasing power for hard goods and non-essential services, eroded by high energy costs and inflation (including high interest), as the cause of loss of jobs and consequent insolvency of businesses and loss of more jobs. I am no economist and come ill-based on statistics, but I see the initiation of much of the inflation since 1973 and business failures since 1973 as based on the high cost of foreign petroleum which is both our fuel and the building block for so much of our manufacturing products. As I see it, even this petroleum and energy inflation would be satisfactory in the long run if it were for purchases of domestic petroleum developed at very high cost internally. That is, petroleum based high inflation would be palatable to me if it were for domestic energy products rather than foreign petroleum which drains so much of our nations' potential capitol to foreign interests to the detriment of our international balance of payments and thus doubly inflationary.

As I complete these comments, I note that your letter requested my response before March 19, 1982. I apologize, but must add that my own duties and responsibilities to regularly preside inside court over 30 hours per week and the press of the ever increasing volume of hearings and opinions and orders demanding a 60-70 hour official work week keeps me constantly and regretably behind these past few many months.

Respectfully yours,

William L. Norton, Jr.

William L. Norton, Jr.

ba

Failure Trends Since 1920

Year	Number of Failures	Failure Rate Per 10,000 Listed Concerns
1920	8,881	48
1921	19,652	102
1922	23,676	120
1923	18,718	93
1924	20,615	100
1925	21,214	100
1926	21,773	101
1927	23,146	106
1928	23,842	109
1929	22,909	104
1930	26,355	122
1931	28,285	133
1932	31,822	154
1933	19,859	100
1934	12,091	61
1935	12,244	62
1936	9,607	48
1937	9,490	46
1938	12,836	61
1939	14,768	70
1940	13,619	63
1941	11,848	55
1942	9,405	45
1943	3,221	16
1944	1,222	7
1945	809	4
1946	1,129	5
1947	3,474	14
1948	5,250	20
1949	9,246	34
1950	9,162	34
1951	8,058	31
1952	7,611	29
1953	8,862	33
1954	11,086	42
1955	10,969	42
1956	12,686	48
1957	13,739	52
1958	14,964	56
1959	14,053	52
1960	15,445	57
1961	17,075	64
1962	15,782	61
1963	14,374	56
1964	13,501	53
1965	13,514	53
1966	13,061	52
1967	12,364	49
1968	9,636	39
1969	9,154	37
1970	10,748	44
1971	10,326	42
1972	9,566	38
1973	9,345	36
1974	9,915	38
1975	11,432	43
1976	9,628	35
1977	7,919	28
1978	6,619	24
1979	7,564	28
1980	11,742	42
1981 *	16,800 (est.)	62 (est.)
1982 *	25,000 (est.)	88 (est.)

SOURCE: DUN & BRADSTREET

* SOURCE: SMALL BUSINESS ADMINISTRATI

Failure Rates Over Time Per 10,000

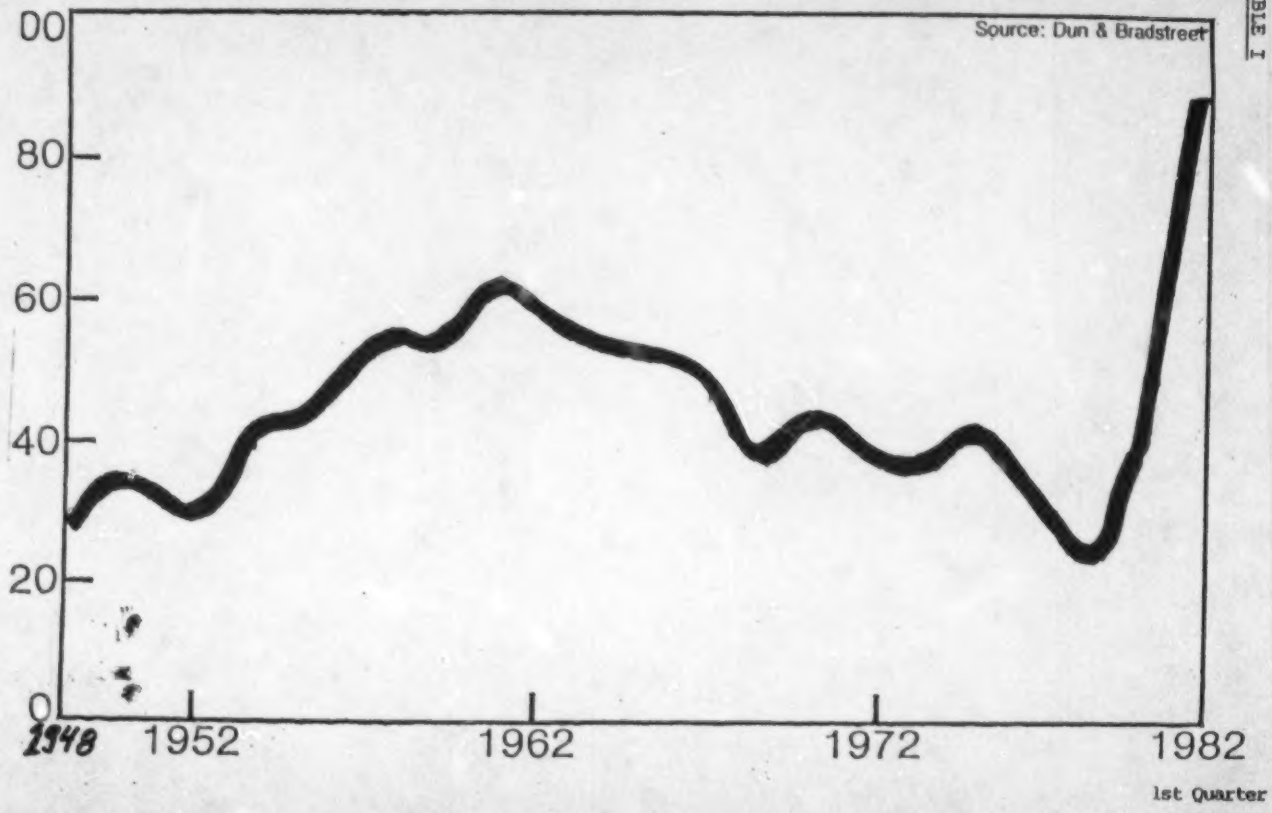
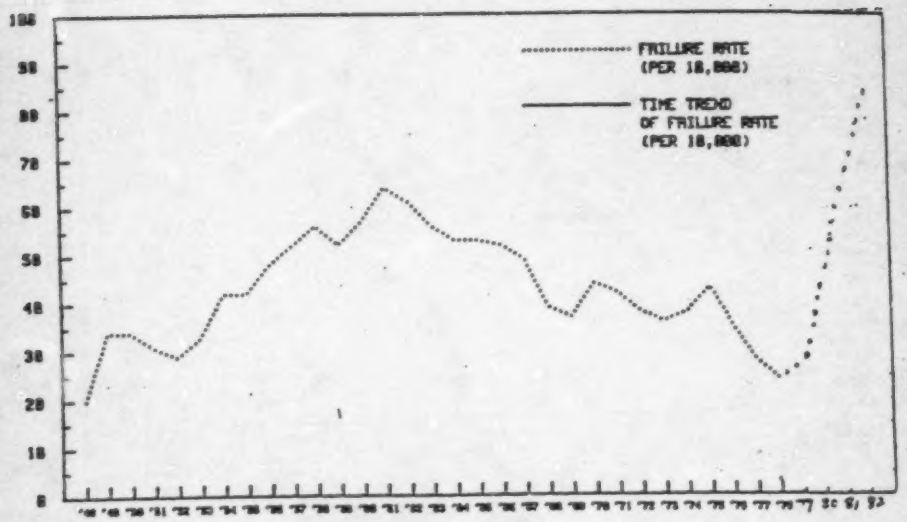


TABLE I

TABLE II

FAILURE RATES OVER TIME



Sources: Dun & Bradstreet, The Business Failure Record for 1978, and Appendix A, Table A-1

United States Bankruptcy Court
CENTRAL DISTRICT OF CALIFORNIA
816 FEDERAL BUILDING
34 CIVIC CENTER PLAZA
SANTA ANA, CALIFORNIA 92701

AARON K. PHELPS
PETER M. ELLIOTT
BANKRUPTCY JUDGES

CLERK'S OFFICE
TELEPHONE
(714) 836-2838

March 10, 1982

Honorable John J. LaFalce,
U.S. House of Representatives
Chairman, Subcommittee on
General Oversight
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman LaFalce:

I am replying to your letter to me of March 2, 1982.

I would say that the major cause of small business failures is high interest rates. We are seeing hundreds, if not thousands, of consumer cases that are filed in a last-ditch effort by a homeowner to save his family residence (again, caused by high interest rates), and many insolvency proceedings by contractors, developers, real estate brokers and second trust deed companies, also caused by high interest rates.

The small and large companies not involved in real estate are also severely impacted by high interest rates. These companies usually have loans with major banks and other lenders based on 2-1/2 to 6% or more over prime, and they just don't have the financial resources to finance the acquisition of raw materials and carry their inventory until sale.

Sincerely yours,

PETER M. ELLIOTT
Bankruptcy Judge

PME/lpk

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
FEDERAL BUILDING—U. S. COURT HOUSE
1100 COMMERCE
DALLAS, TEXAS 75242

DEAN M. GANDY
BANKRUPTCY JUDGE

March 16, 1982

MAR 1 - 1982

Hon. John J. LaFalce, Chairman
Committee on Small Business
Sub-Committee on General Oversight
2361 Rayburn House Office Bldg.
Washington, DC 20515

Dear Congressman LaFalce:

I did not receive your letter of March 4 until March 12, and hence must answer it immediately in order to get it to you by March 19. I appreciate your giving me this opportunity to comment on my impressions of why small businesses fail. It is a subject that interests me greatly, I have spoken on it several times in the past, and would be glad to supplement this letter after March 19 with more detail if that might later be possible.

In my opinion, the reasons small businesses fail fit generally into two large categories. The first category is economic. Within that general category, I observe the following causes:

1. Imbalance in cash flow. This can result from inadequate capital, combined with expensive and scarce credit. A case I am trying this week involves a company with approximately $5 million a year in gross sales, which has been borrowing money to cover losses to such an extent that the interest charges quoted at 6% over prime are presently equalling $1.2 million each year. Obviously, that company could not bear such a large interest burden, and when the bank called its loan, it had no alternative but to file a Chapter 11, and hope to arrange its finances in an orderly fashion to reduce its debts, and restore a degree of profitability that would cover the debts as stretched out. In the early 70's we experienced a rash of construction bankruptcies, which were all related to the fact that given companies had bid jobs assuming labor and material costs at a fixed level, but inflation accelerated to such an extent that the rise was not anticipated, and what were otherwise profitable contracts, became disasters to the companies involved.

The rapid, unanticipated inflationary increase in construction also wreaked havoc with owners of buildings or restaurants that had commenced a remodeling program. No estimates of costs were ever reliable, and the owners who had projected levels of expenses at one figure, and found that they were being billed at figures 50-100% higher than the projected figure, simply could not weather this unexpected increase.

2. Loose management policies. This condition exists normally when there is easy, bludgeoning growth in a certain industry during a certain period, followed by a recession in that industry to which the business does not quickly adjust. This is related to the third economic cause which I shall mention later, but it is more general. Symptoms of this condition are the apparent "need" for private jet airplanes, management suites, and similar prerequisites. These do not cause the downfall of the business, but are indicative that management is less concerned with costs than may have been the case in the early days of the business. An attrition of discipline occurs, and when the hard times follow the good times, there is not a quick enough elimination of excess payroll, and other costs.

3. Exceptional prosperity in given industries that bring in less competent individuals who cannot adjust to subsequent recessions. An example of this specific cause would be the small oil operators at the present time. Because of the excess profitability in the oil business at the present time, many individuals with little competence in the industry have entered it, and when the slightest problems are encountered, the free enterprise system tends to winnow them out. They have no other alternative but to seek bankruptcy protection. Another example would be the computer industry in the late 60's. At that time, before Japanese competition became significant, the making of money in the software industry was relatively easy. The giant of the industry, I.B.M., had priced its hardware on a competitive level to dominate that market, but had priced its software at a much higher level which permitted successful competition by a multitude of small software computer companies. They could also, by limiting themselves to software, avoid the built-in obsolescence problem that the larger companies experienced. However, by the late 60's and early 70's, I.B.M. changed its pricing policies to be less competitive in the hardware industry, but more

competitive in the software industry, and the smaller software companies who failed to adjust and successfully compete, fell by the wayside. Under this general category, I would also include businesses that fail because of the injection of external factors that no one anticipated, and to which the business cannot successfully adjust. The last cited illustration of the computer business may be involved here. Another example would be the real estate companies owning and specializing in raw land in the early 70's. Dallas and its environs, at that time, experienced a phenomenal growth in the value of raw land, and many sales between all of the various traders in this commodity occurred at this time, with a great deal of profit to all concerned. However, when the Yom Kippur oil embargo hit suddenly, the fact that undeveloped land situated many miles from the city might be affected by transportation problems dawned on the general public, and thus, the value of the raw land plummeted, along with all of the profits that had been earned, leaving many of the owners with large notes, substantial deficiencies in the collateral securing those notes, and no longer a profitable cash flow.

The second general category causing small businesses to file for bankruptcy would be the change in moral thinking in this country in the last few decades. This is an even greater reason to assign for consumer bankruptcies. Businessmen once took bankruptcy only as a last resort. Now, I think they probably resolve a decision in favor of a bankruptcy filing at an earlier point in time than they would in the past. This is not altogether bad since Chapter 11 cases now are, in my opinion, generally more successful than they were in the past when the patient was moribund at the time of filing. Large bankruptcies like Pennsylvania Railroad, W. T. Grant, or Omega-Alpha, with all of their resultant publicity, seem to have encouraged the small businessman to do likewise. The social stigma of bankruptcy is no longer as strong as it once was.

One factor which I do <u>not</u> assign as a reason for the increase in filings is the new Code. On the contrary, because of uncertainty regarding the Code in its early days, I think the change in the law may have depressed the filings beyond what they would have been under the Act. I do think that the fact Bankruptcy Clerk offices and Bankruptcy Courts are handling 300-400% more business than they handled before, with the same number of bankruptcy judges as before, has created an enormous strain on the system. Yet, in spite

of this strain, I do think the Code is working successfully in solving, within the judicial framework, many of the debtor/creditor problems that before were not successfully resolved.

To answer specific portions of your letter, as noted above, I think that small oil companies in my area are the types of concern whose numbers are increasing at the present time. Construction companies and land holding companies also continue to file, but, because of the general prosperity in Dallas, the ordinary mercantile company is generally successful.

As to comparing trends in the past decade, and comparing the 1974-75 recession to the current recession, you will note that I have covered specific industries in the above comments. In the Dallas Division of the Northern District of Texas, bankruptcies have consistently increased in spite of general economic prosperity, and I enclose a schedule showing you that increase and comparing the numbers between 1974-75 and 1980-81. As noted above, there were more real estate and construction companies in the early 70's than we now experience.

I hope that the above is helpful. It comes from twelve years experience on the bench, four years general practice of bankruptcy and oil and gas law, and thirteen years in the oil business. Please let me know if I can be of any further help to you.

Very truly yours,

Dean M. Gandy
Bankruptcy Judge

DMG:jh

Enc.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

BUSINESS BANKRUPTCIES FILED UNDER THE ACT (CHAPTERS VII & XI) AND THE CODE (CHAPTERS 7 & 11)

1972	130	
1973	169	
1974	215	
1975	325	
1976	288	
1977	232	
1978	246	
1979	290	
1980	334	
1981	529	
1982	124	as of 3/12/82

1974	215	1980	334
1975	325	1981	529
	540		863

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK
BUFFALO, N. Y. 14202

JOHN W. CREAHAN
U. S. BANKRUPTCY JUDGE

MAR 16 1982
Hand delivered
9:30 am
LV

March 15, 1982

Honorable John J. LaFalce, Chairman
Committee on Small Business
Subcommittee on General Oversight
United States House of Representatives
2361 Rayburn House Office Building
Washington, D. C. 20515

RECE
MAR

Dear Congressman LaFalce:

We have received your inquiry dated March 4, 1982 and, since our views coincide, have elected to forward a joint response.

I

As Appendix 1 to this letter, we first include a table of business filings for the geographic area served by the two bankruptcy judges stationed at Buffalo (which embraces the eight most westerly counties of the Western District of New York). You will note that in 1980, 11.6% of our overall filings were business filings. That percentage rose to almost 14% in 1981 and, for the first two months of 1982 rose to 18.9%. While our statistical records do not differentiate among business cases based on size, we believe that in this district, most of the business cases involved would fall in the small business category.

We would also note that a great many small business cases, in effect, are liquidated for the benefit of a secured creditor under the provisions of New York's Uniform Commercial Code or are just closed by their owners and, hence, are not included in our statistics.

In a small survey of major commercial law firms in this area, which survey was conducted by our Clerk following your inquiry, the attorneys estimated that for every business filed in Bankruptcy Court, two to three non-bankruptcy failures occur.

Second, we include as Appendix 2 selected quotes from a January 19, 1981 TIME magazine article on the state of the economy and business. The article contains observations which we believe are significant and meaningful and which are consistent with our subsequently stated views.

II

The types of business concerns filing bankruptcy cover a very broad spectrum of the business community. They would include restaurants; business contractors and subcontractors; building suppliers; real estate brokers; truckers; furniture, clothing, radio and T.V., auto and other types of retailers; gas station operators; farmers; as well as some allied wholesale distributors in the aforementioned categories. Numerically, retail and service concerns compose the most significant part of these filings.

III

You have asked what we believe is the primary cause of small business bankruptcies. Unfortunately, we cannot isolate a primary cause but can only identify what we believe to be a number of significant factors which, in combination, have severely impacted small business.

Since the new Bankruptcy Code itself currently is being maligned by various segments of the creditor community, it is appropriate to initially note that we do not see the provisions of the new Code as being materially different from the provisions of the former Act insofar as creditors are concerned. We see the new Code as being only a convenient scapegoat for creditors who are justifiably alarmed with the losses being encountered through consumer and business failures..

The factors contributing to small business failure can be readily enumerated. But perhaps mere enumeration is less meaningful than a model. Hence, we will initially focus on the model of a small business, first, as an entity dependent on its customers and, second, as an entity which itself is a customer of goods and services.

A.

First, we address business as an entity dependent upon its customers. Most small businesses, of course, provide products or services to the general public. Hence, the financial health of the average consumer directly impacts upon the sales of small business. Here, the effects of inflation including tax bracket creep, of unemployment and reduced working hours, of the high cost of uninsured medical services, of increasing utility charges, and of high interest

rates upon the discretionary income of the consuming public is frequently witnessed by us and otherwise well documented. We also see cases where a small business is significantly tied to a larger business enterprise or to governmental units. Here, a switch to slow pay by the larger enterprise or governmental unit immediately throws the small business into cash flow distress. In turn, this may require resort to accounts receivable financing, the cost of which a small business may not be able to afford. In addition, the relocation of the larger business either to another state or overseas or the failure of the larger business will sound the death knell for the smaller business.

B.

Addressing the next, the small business as a purchaser of goods and services, its plight is somewhat analogous to that of its customers.

First, many, if not most, small businesses are required to use some form of credit whether it be to purchase capital items, to maintain cash flow through accounts receivable and/or inventory financing, or to maintain inventory of stock through a floor plan credit arrangement. High interest rates, of course, have resulted in this particular cost of business skyrocketing. Second, until recently, inflation persisted at consistently high levels. Consequently, virtually all of the costs of a small business continued to rise at high rates. It appears to us that many small businesses either were unable to or were slow to adjust their pricing to reflect these high costs. This, of course, may be the flip side of the sales problems which they were encountering.

C.

In concluding our observations, it should be emphasized that the above factors are those which, in our judgment, have led even properly managed business into financial difficulties or bankruptcy. The ineptly and improperly managed small business, confronting these factors, inevitably failed.

We would also note that we have encountered a number of small business bankruptcies in which the business had been funded through various federal loan guarantee programs (SBA and FHA, for example). How some of these businesses had qualified for loans defied our understanding.

IV

We hope that our reply is fully responsive to your inquiry. If we can be of any further service to the Committee, we, of course, will be happy to oblige.

With kindest regards, we remain

Respectfully,

John W. Creahan
U.S.B.J.

Beryl E. McGuire
U.S.B.J.

BEM/mlms

1980

Buffalo Division *

Total Business Filings (all chapters)	419
Total Filings	3598
% of Business/Total Filings -	11.645%

1981

Buffalo Division *

Total Business Filings (all chapters)	529
Total Filings	3790
% of Business/Total Filings -	13.958%

First 2 Months of 1982

Buffalo Division *

Total Business Filings (all chapters)	109
Total Filings	577
% of Business/Total Filings -	18.890%

* Includes Counties of Erie, Chautauqua, Cattaraugus, Allegany, Niagara, Genesee, Orleans and Wyoming.

APPENDIX 1

TIME Magazine, January 19, 1981

. . . the 1980 slump was exceptionally severe: it knocked down the output of goods and services at an annual rate of 9.9% in the second quarter, added 1.7 million people to the jobless rolls in April and May, and contributed to the largest quarter-to-quarter surge in unemployment ever recorded in statistics that date back to 1940. The recovery that followed was the shortest on record, and very weak. In much of the nation it was never even felt. The unemployment rate, for instance, dropped only from a peak of 7.8% in May and July to 7.4% in December, and now is expected to go up again, probably past 8%.

* * *

Consumer prices rose about 13% in 1980, after a 13.3% jump in 1979. Nothing like that had happened in 60 years. The previous peak was the four straight years 1916-1919 during and immediately after World War I. Worse, nothing is in sight to prevent another year of inflation in 1981. The consensus forecast of TIME's Board of Economists is that prices this year will shoot up an additional 11.4%.

* * *

Through much of the decade, however, American incomes increased faster than the rise in prices. That occurred in part because the earnings of working wives bolstered family incomes. But since early 1979, inflation has steadily outstripped the rise in wages per hour, so that the American standard of living is now genuinely falling.

APPENDIX 2

U.S. Department of Justice

United States Trustee
Districts of Minnesota, North Dakota and South Dakota

United States Courthouse, Room 550
110 South Fourth Street
Minneapolis, Minnesota 55401

612/725-4191
FTS/725-4191

March 12, 1982

The Honorable John J. LaFalce
Chairman, Committee on Small Business
Subcommittee on General Oversight
2361 Rayburn House Office Building
Washington, D.C. 20515

RECEIVED
MAR

Dear Mr. Chairman:

This is in response to your letter of March 4, 1982 requesting my impressions on why small businesses are filing bankruptcy cases and the factors behind the increase in the past year.

The two primary causes for the increase in bankruptcies generally, as well as for small businesses in particular, are the extremely high interest rates and the length of the current recession.

Let me cite two examples bearing on my contention that these are the two primary causes of failures. I have had cases where a home builder has had to pay as much as seven points above a prime rate of 18 or 19% in order to obtain a construction loan. Just yesterday a restaurant owner in South Dakota, who filed a reorganization petition in bankruptcy court a year ago, was in my office and he stated that a year ago he expected an upturn in the general economic picture, but instead it had turned even more downward in the past year.

While it is generally believed that "mismanagement" is a large factor in the failure of small businesses, based on testimony I have heard in Chapter 11 cases involving various small businesses over the past 2-1/2 years, it is my impression that bad judgment, improper bookkeeping, etc. are a causative factor in only about 10% of the cases. The incidence of bankruptcies has increased particularly for small businesses in the construction industry and for concerns related to the automobile industry, such as, automobile dealerships and parts and service businesses. These two areas of economic activity were particularly hard hit during the period of October 1, 1979 to September 30, 1981. For the fiscal year ending September 30, 1981, 13.6% of the Chapter 11 cases in this three-state area of Minnesota, South Dakota and North Dakota were filed by construction related businesses. Many of these debtors testified that

the high interest rates had all but completely extinguished any new activity in either residential or commercial construction.

Currently, we are experiencing a dramatic increase in Chapter 11 petitions by farmers and ranchers. In the last fiscal year we had a total of 19 reorganization cases or 12.3% filed by farmers or ranchers. Since October 1, 1981 and through March 11, 1982, we have had 43 such cases for a 226% increase with more than six months remaining in this fiscal year. The Minneapolis Tribune of March 11, 1982 reported that the Farmers Home Administration Office in Minnesota had stated that out of 16,068 farm loans outstanding, 7,885 were delinquent. As to farmers, many (but not all) had experienced dry growing conditions or hail in the 1979 and 1980 crop seasons. In 1981 most had good crops with average or above normal yields, but the market price for their crops had fallen so low that their cash receipts from a good crop were insufficient to put them back on their feet after the dry year losses. Yet each believed that with normal growing conditions and an increase in market prices, they would be able to prepare a plan for paying off their creditors, provided they could get an operating loan to put in the 1982 crop.

I regret that I am unable to make any comparison with the 1974-75 recession or to comment on trends during the past decade, since during that period I was not associated with bankruptcy matters but was on the staff of the Senate Judiciary Committee.

I trust that the information contained in this letter will be of assistance to you and your Committee in your oversight functions.

Sincerely,

William P. Westphal Sr.
United States Trustee

WPW:jw

U.S. Department of Justice

United States Trustee
Central District of California

United States Courthouse, Room 514
312 North Spring Street
Los Angeles, California 90012

213/688-6811
FTS/798-6811

March 19, 1982

RECEIVED
MAR 2 3 1982

Honorable John J. LaFalce
Chairman, Small Business General Oversight Subcommittee
United States House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Honorable John J. LaFalce:

This is in response to your letter of March 4, 1982, concerning the impressions which I as United States Trustee, Central District of California may have concerning the primary cause of small business bankruptcies and the types of concerns which are filing under bankruptcy or reorganization.

My impression is that high interest rates and the current, attendant recession are the primary reasons why the number of business bankruptcies have risen substantially during the past 6-12 months. And small businesses, because they may not have a well-established credit rating, commonly must bear the highest interest rates.

On the other hand, the high interest rates, in my view, only acerbate other underlying problems which businesses in serious financial trouble may have. These are the more traditional problems such as undercapitalization, poor management and accounting, inexperience or poor judgment concerning the demand for a product. These latter, more traditional reasons are neither complete nor mutually exclusive, however.

But they reflect reasons which businesses generally fail and file under Chapter 7 for liquidation or file under Chapter 11 for rehabilitation. The above, general reasons have been prevalent during both the 1974-75 recession as well as the current recession.

What is different during this recession is the relatively long period of sustained high interest rates and the depth of the impact on the real estate industry. As in any capital intensive industry, in the real estate field both the seller-manufacturer and the buyer are directly affected by interest rates since both normally must borrow.

Our office has kept a separate tally of the number of cases in which real estate is the primary asset over the past six months and has found that such cases comprise fully one half of all cases filed under Chapter 11. Further, the increase in cases filed under Chapter 13 has been caused primarily by more homeowners seeking to protect their home ownership interest from foreclosure.

This is not to overlook the new focus on bankruptcy as an alternative generally. The increase in attention on bankruptcy stems, in part, from greater advertising by practitioners and a continually changing attitude concerning the "stigma" of filing for protection under the bankruptcy law. I enclose a copy of a recently published article citing this change.

If I can be of further assistance, please do not hesitate to write or call.

Sincerely,

JAMES T. EICHSTAEDT
United States Trustee

Enclosure:
As stated

cc: Quinlan J. Shea, Jr.
Director, Executive Office of U.S. Trustees

U.S. Department of Justice

United States Trustee
Northern District of Texas

SHB:sk:trs

United States Courthouse, Room 9C60
1100 Commerce Street
Dallas, Texas 75242

214/767-8967
FTS/729-8967

March 24, 1982

Honorable John J. LaFalce
Chairman, Committee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, D. C. 20615

Dear Congressman LaFalce:

I thank you for your inquiry regarding an aspect of our economy I am so vitally involved with. It is with sensitive thought and concern that I topically address your letter of March 4, 1982.

1. THE UNIQUE POSITION OF THE UNITED STATES TRUSTEE TO VIEW CAUSES OF SMALL BUSINESS BANKRUPTCIES.

The Bankruptcy Reform Act of 1978 removes case administrative responsibility from the Bankruptcy Courts and places it with the ten pilot district United States Trustees. With administrative responsibility comes a unique perspective into precipitating causes and consistencies common to all types of small business endeavors. Not common to all pilot districts, but a requirement in the Northern District of Texas, is an immediate and initial debtor interview. I mention the debtor interview because of it's value in gaining insight into the precipitating main and underlying causes for the filing. The combinations of overall case administration responsibility, subsequent monitoring reports required by our office, creditor meetings (now styled Section 341 meetings) and ongoing post-petition debtor and creditor contact serve to position the United States Trustee to provide an informed perspective into small business bankruptcies.

2. WHY SMALL BUSINESSES ARE FILING.

I am addressing the corporate and individual debtor separately, although characterizing both classes as small businesses.

Regarding the corporate debtor, a myriad of causes and circumstances exist. Among the most visible to the public;

a) high interest rates have burdened debtors of marginal profitability and at times traditional profits have been exceeded by increased interest margins. Additionally, interest payments tax the debtor's operating capital availability. Concurrent with high interest rates has come an era of "tight money", resulting in either request for high equity loans or personal guarantees to corporate borrowing from principals or investors.

b) Management abilities have remained the same and are not related to adverse economic times. However, the management team that is tentative with regard to decision making is impaired operationally during adverse economic periods. Many chapter proceedings are commenced by debtors lacking vital "in the trench" management experience. Regularly debtor management is grounded with sales and marketing ability.

Regarding the individual debtor operation, a small businessman tends to have less financial sophistication and need. Pursuant to Title 11 United States Code, this debtor has Chapter 13 as an additional option, provided it meets certain parameter requirements. I will not promote theories directed toward moral decay and "it is now easier for an individual to file bankruptcy." However, I will state my belief that allowances of both State and Federal exemptions create an attractive incentive for individual debtor filing. The result of forestated exemptions and local lawyer advertising is increased individual business bankruptcies.

For both corporate and individual businesses, overexpansion of product or market is almost always an underlying factor. Possibly my conservative views become evident, but an expansion based upon success usually has principal cash, stability and roots. In the alternative an alarming number of chapter debtors are guilty of speculative expansion using existing assets as collateral to new projects. Hence, the stamina to endure peaks and valleys of our economy is weakened if not destroyed.

Undercapitalization, a catch-all description used to identify debtor failures, is in need of further practical definition and application. It is my experience that a vast majority of debtors do not know their capital needs or requirements. In furtherance of their uncertain cash needs, it is apparent that the subject of "cash flow" and "cash management" is poorly understood. In other words "capitalization" is directly related to the management team and it's resulting decision making. Please understand that this is a complicated topic, however, capture the spirit of my belief that most failures are precipitated by poor understanding of these principles. Once the cash pressures begin, one bad decision begets another. At some point, and usually after having mortgaged everything, the debtors give up.

3. FACTORS BEHIND BANKRUPTCY FILINGS DURING PAST YEARS AND PRIMARY CAUSES OF BUSINESS FAILURES.

A "ripple effect" is a good way to illustrate. We have had many debtors whose creditors have had to file at later dates. Additionally, uncertainty is created when a seemingly key company to a particular industry fails. Ongoing high interest rates have created a business atmosphere of hopelessness. An action deserves a reaction, and this is precisely what is occurring between lenders and borrowers. Debtors become depressed and lenders become worried, the result is tighter money and bankruptcy.

4. TYPES OF BUSINESSES FILING FOR BANKRUPTCY.

The types of businesses filing for bankruptcy vary by district. Within my district the most depressed markets are:

- Residential housing and home building (included in this category are all subcontractors and suppliers)
- Automotive and truck dealers
- Farm implement dealers
- Farmers and ranchers (on a voluntary basis)
- Oil promoters
- Oil field supply companies (recent trend)
- Restaurant and other eating establishments
- Small oil refineries and pipelines

5. TRENDS NOTED OVER THE PAST DECADE:

- Interest rates have progressively increased.
- The rate of inflation has steadily accelerated spawning a "purchase before another price increase" philosophy.
- A now common attitude is "borrow and pay back with cheaper dollars."
- Unstable fuel prices and uncertain availability are a reality.
- Labor costs have increased.
- Difficulty acquiring semi-skilled and unskilled labor has become a management frustration.

The forestated trends and facts are in no way inclusive of all contributors to the small business calamity. However, I know of no one who would dispute their listing within this context.

6. COMPARISON OF SMALL BUSINESS BANKRUPTCIES DURING THE 1974-1975 RECESSION AND CURRENT RECESSION.

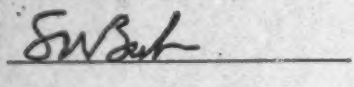
The 1974-1975 recession was somewhat contemporaneous with the October 1973 oil embargo. This occurrence severely affected the automotive industry. Our economy is seemingly interdependent upon the automotive industry with approximately one of every six or seven American workers employed directly or indirectly by this industry. Americans for the first time ever were faced with the loss of our bloodline, petroleum. Notwithstanding, the petroleum crisis did not, in total, create a business climate of recession. However, it did contribute to a recession that was more severe to locales dependent upon petroleum and petroleum based equipment.

The tentacles of the current recession reach to all communities, at all locations. Even the glorious Sunbelt has not been insulated. The current recession is much more severe than the 1974-1975 recession. Besides the factual differences already cited, the current recession will be the first recession under the new Bankruptcy Code enacted October 1, 1979. It will be interesting to note the different treatment accorded debtors and creditors under the new Code as compared to the old Bankruptcy Act.

In closing, although many businesses are insolvent, they are not in bankruptcy because they have not lost the ability to deal with creditors. However, for whatever reasons, more and more debtors are losing their ability to deal with their creditors and are seeking the protection of the Bankruptcy Courts.

Sincerely,

SCOTT H. BUSH
UNITED STATES TRUSTEE
NORTHERN DISTRICT OF TEXAS



U.S. Department of Justice

United States Trustee
Southern District of New York

Federal Building, Room 306
26 Federal Plaza
New York, New York 10007

212/264-2858
FTS/264-2858

March 18, 1982

Honorable John J. LaFalce
Chairman, Subcommittee on General Oversight
Committee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman LaFalce:

This is in response to your inquiry, dated March 4, 1982, seeking information about the types of small businesses that are encountering financial difficulties and our impressions of the reasons that an increasing number of such businesses are seeking refuge in the bankruptcy courts.

As United States Trustee for the Southern District of New York, the perspective from which I respond is based solely on the bankruptcy filings in this District, which consists of the counties of New York, Bronx, Westchester, Rockland, Putnam, Dutchess, Orange and Sullivan. Moreover, the impressions that I and my staff have formed as to the reasons for the financial difficulties encountered by small businesses come from information provided to us by debtors, and in some cases by creditors, and not from any independent investigation conducted by us. Because the United States Trustee pilot project became effective on October 1, 1979, the effective date of the Bankruptcy Reform Act of 1978, neither I nor my staff are in a position to comment upon trends in small business bankruptcies during the past decade. For that reason, we also are unable to make a comparison of causes of financial difficulties in the recent period to those in the 1974-1975 period.

1. During the past few months we have seen an increase in filings by companies in the textile industry (primarily clothing manufacturers), by companies in the jewelry business, by companies engaged in operating coffee shops or luncheonettes, and by real estate holding companies. We have observed recently that more of these concerns now appear to be less viable as of the date they commenc their respective Chapter 11 cases than similar businesses that commenced such cases in the earlier period of this Office's tenure. Our impression is that that may be caused by such factors as that they may have waited too long to seek the protection of bankruptcy, they are family businesses in which the family members may find it difficult to change the manner in which they operate, or substantial sums may have been borrowed and the cost of such funds is higher than current income.

We also have noticed recently that in the five counties north of New York City there has been an increase in the number of filings that have involved small businesses that were no more than a year or so old and were begun by persons believed to be in the range of age between late 20's to late 30's.

2. A primary reason for bankruptcy filings by small businesses (as well as large ones) appears to relate to liquidity. That is, businesses are encountering cash flow problems and thus are not able to pay their debts as they become due. This difficulty in servicing debt seems to be caused by the fact that businesses are highly leveraged and/or by high interest payments on borrowed funds.

In a number of cases, it appears that small businesses have maintained higher inventory levels than one would expect to be optimal in the current economic environment and they have had difficulty in turning these inventories into cash. This appears to occur most often, for example, where a small manufacturer (most often in the textile industry) produces its product primarily for one or two large retail customers, who suddenly reduce the quantities they purchase because the goods are selling slowly or not at all. Coupled with that also appear to be difficulties being encountered by businesses in collecting receivables. Either of the two factors described have the effect of reducing cash availability. In many cases where this has occurred, the businesses have sharply curtailed their operations and are hopeful that the economic environment will improve.

In addition, we have noted that fluctuations in the prices of precious metals and gems are having an impact on businesses that deal in jewelry. Moreover, some businesses appear to have encountered financial difficulties due, for example, to inefficiencies that result from obsolete equipment and the inability to acquire more up-to-date replacement equipment because of a lack of cash or the high cost of financing purchases.

* * * * *

I am pleased to provide the Subcommittee with the foregoing information in response to its inquiry about business bankruptcies. In the event the Subcommittee wishes its staff to review any of this Office's case files, they are available for inspection.

Sincerely,

Irving H. Picard

Irving H. Picard
United States Trustee

IHP/lc

cc: Quinlan J. Shea, Jr.
Director, EOUST

U.S. Department of Justice

United States Trustee
Districts of Delaware and New Jersey

1180 Raymond Boulevard, Room 2549 *201/645-2617*
Newark, New Jersey 07102 *FTS/341-2617*

March 22, 1982

John J. LaFalce, Chairman
U. S. House of Representatives
Committee on Small Business
Subcommittee on General Oversight
2361 Rayburn House Office Building
Washington, DC 20515

Dear Congressman LaFalce:

In response to your recent communication relative to your Committee's concern and interest in what causes small business bankruptcies, the following represents what I consider the major factors involved in small business failures:

1 - Substantial increase in interest rates over a short span of time.

2 - A substantial increase in utility costs.

3 - Higher demands for wages and benefits by employees.

4 - Inability to purchase raw materials because of the tightening of credit by major suppliers.

5 - Depletion of inventories precipitated by reduction in borrowing capacity. Small businesses that are forced to rely on back up inventory that cannot be replaced on a regular basis, cannot properly and effectively meet the demands of customers for inventory mix requirements. A customer that cannot fill an order completely, often opts to purchase its merchandise from a supplier that has an adequate and readily available mix of inventory.

6 - General concern in the market place about problems in certain industries which adversely affect the operations of certain small businesses.

7 - Inability to compete with large competitors in the areas of selling prices and services.

U.S. Department of Justice

United States Trustee
Districts of Delaware and New Jersey

1180 Raymond Boulevard, Room 2549 *201/645-2617*
Newark, New Jersey 07102 *FTS/341-2617*

In my opinion, if spiralling interests and energy costs were not part of the reasons for small business failures, many small businesses, with proper attention, could survive and continue to operate.

There are some other factors that should be considered as additional reasons for small business problems and they are:

1 - The closing, or retrenching, of a large entity that has occurred more frequently during the past two years, hurts small businesses in the immediate area. Small service, retail and manufacturing operations that rely on orders from larger companies, or servicing employees of larger businesses, obviously will encounter severe financial problems when a primary source of their existence leaves the area.

2 - For the past several years, small businesses were able to receive financial assistance through low interest loans guaranteed by the government. Unfortunately, many businesses that qualified for SBA type loans, were unable to survive primarily because of the borrower's lack of business experience.

Although I did not serve as United States Trustee during 1974 and 1975, I did work as a private practitioner in the area of insolvency and for that reason, I am familiar with generally, what precipitated small business filings during that period. In my opinion, many of the same factors that have caused the current downtrend, precipitated small business filings in the middle seventies. As compared to current problems, the mid-seventy recession did not last long and there was minimal damage to basic industries. Damage to basic industries, such as automobile, construction, steel, etc., will extend the recovery period.

Further, as I recall, there was also a shortage of money during 1974 and 1975 that imposed an additional financial burden on small businesses.

U.S. Department of Justice

United States Trustee
Districts of Delaware and New Jersey

1180 Raymond Boulevard, Room 2549 *201/645-2617*
Newark, New Jersey 07102 *FTS/341-2617*

I hope that the content of this communication is of some benefit to your Committee.

Respectfully,

HUGH M. LEONARD
UNITED STATES TRUSTEE

HML/dj

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
219 SOUTH DEARBORN STREET
CHICAGO, ILLINOIS 60604

CHARLES B. McCORMICK
JUDGE

TELEPHONE
(312) 435-5645

March 22, 1982

MAR 24 1982

Congressman John J. LaFalce
United States House of Representatives
Committee on Small Business
Subcommittee on General Oversight
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman,

Kindly excuse my tardiness in answering your letter of March 4, 1982.

In ordinary economic times small businesses are forced into bankruptcy for three basic reasons. They were either ill-conceived or under-capitalized or the parties were not capable. Frequently the cause was a combination of these.

Today, small business bankruptcy is so common that it is difficult to single out one or more specific types as being preponderant. Certainly home construction companies and business related to the building industry are in the forefront. Automobile dealerships are also failing though some are hanging on in Chapter 11 proceedings. Many restaurants are failing but that business has always had a high incidence of bankruptcy.

My experience is that there is no comparison between the filings of 1974-75. I have no specific recollection of serious problems during 1974-75. Surely nothing remotely comparable to the terribly worrisome number of filings over the past year or two.

I am possessed of no particularly erudite insight as to the causes of the great increase in small business bankrupty filings. The increase must, I feel, be blamed on the common elements of high interest, tight money, inflation, the loss of jobs due to plant closings and the farming out of work to foreign countries and the other ills that greet one in the media every day. I see these elements as causing the business failures and am deeply concerned as they seem to have a cumulative or snowballing effect on filings and on the economy in general.

Sincerely,

Charles B. McCormick
U.S. Bankruptcy Judge

CBMcC:dk

United States Bankruptcy Court
For the
Middle District of North Carolina

Rufus M. Reynolds
U.S. Bankruptcy Judge
Tel. (919) 378-3134

U.S. Post Office & Courts
324 West Market Street
Post Office Box 1370
Greensboro, North Carolina
27402

March 8, 1982

The Honorable John J. LaFalce
United States House of Representatives
Committee on Small Business
Subcommittee on General Oversight
2361 Rayburn House Office Building
Washington, D. C. 20515

RECEIVED
MAR 16 1982

Dear Mr. LaFalce:

Your letter of March 4, 1982, in regard to the failure of small businesses has been received.

I have examined our docket sheets for Chapter 11 reorganization business cases filed during the last two years. These cases were examined in regard to the type of businesses and trades which they were related to. I have been personally exposed to several hundred business cases under Chapter 13, more frequently referred to as the "mom and pop" businesses. Liquidation cases under Chapter 7 as well as the 13's have a general pattern along with the reorganization cases. In connection with the cases filed, I would like to make the following observations.

The types of business cases filed fall in the larger groups as follows:

1. Construction and building trade

The contract construction building trade has been hit the hardest of all. Over 30% of all the reorganization cases fall within this related field. They would include contractors, material furnishers, building materials sales, businesses, carpeting, furniture, metal fabricating material for construction, grading, etc.

Reason for filing

In my opinion, there are two main reasons for so many cases being filed in the building trade. First, construction work has come almost to a halt in all fields. Without new residences there is a much smaller demand for furnishings. The second reason is the high rate of interest. The high rate of interest, of course, has caused the construction shortage.

2. Retail stores

The retail stores make up about 15% of the filings in the business reorganization.

Reason for filing

Since there are so many retail stores there are natually a number of casualties in this field. The number of filings have been increased, in my opinion, by the cost of money. Interest rates running at 15% to 25% are so expensive that the borderline retail store cannot survive.

3. Textiles

Nor[illegible] Carolina, and especially my District, is noted for the number of textile employees and textile companies. Even though the percentage is small in filings, usually the cases are rather large and have a very broad effect.

Reason for filing

The main reason for filing is twofold: one, imports have been a major disaster to textiles, especially in the cutting and sewing. Secondly, it takes capital for the textiles to operate. This working capital is so expensive at 20% to 25% the marginal companies cannot survive.

4. Trucking businesses

There has been a surprising number of small truck haulers and truck businesses filing. About 12% of the cases have been in this field. This is an unusual situation.

Reason for filing

There are two main reasons for filing in the trucking field. One, the truck hauling has been deregulated and every little fellow thinks he can become a successful hauler. Therefore, there have been many, many, more peo[illegible] on a small scale getting into trucking. After they get in, they find that they are at the mercy of the established truck lines. They get only the ove[illegible] age that the other successful truck lines have to give them. Then they are faced with a high rate of interest on their equipment. Their payment, including interest, amount to more than they can make.

5. Egg production

For the first time in about 10 years the egg producers are finding that they have not been able to break even in most of the operation during the past two years. The cost of grain has gone substantially high while the price of eggs has gone down to what they were ten years ago. This happens to be a result of this particular commodity or consumer product rather than the cost of money.

In my opinion, bankruptcy cases generally have been substantially increasing during the last two years by reason of four things as follows:

1. Interest and the cost of money. Very few little businesses can afford to pay 25% for capital and those who have not filed are facing slow death. The cost of money is getting so high even the biggest and best known companies in the United States are now going through as long as 45 days to pay their trade accounts. The weaker companies even take 60 days. The marginal man cannot pay 25% for working capital and wait 60 days to collect his accounts receivable. That is the big pitfall we are running into.

2. Weakness in particular trades. As noted above, certain types of businesses are having a major depression at this time, including the building trade, the textiles, some motels, egg production, and trucking businesses. It is naturally expected that there will be more filings in these businesses.

3. Inflation. Inflation has a major effect on the increase of individual filings and some effect on small businesses. The effect on small businesses is not as great as it is on individuals but it is still a large problem.

4. New Bankruptcy Code. In my opinion, the new Bankruptcy Code has been the cause of the increase in a large number of filings, both individuals and corporations. The public has learned there is something new that Congress has passed and many people want to rush and see what there is for them. This psychological approach coupled with the fact that now lawyers are advertising for bankruptcy cases which they have never done before have brought forward the rapid filing rate.

I would like to point out that in our District 78% of all cases filed are filed under Chapter 11 and Chapter 13 for rehabilitation with hope and an effort to pay their debts. No other District in the United States has that high a percentage for that type of cases. I find that people and small businesses want to pay their debts in North Carolina and we sure encourage them to do so. (75% of all the cases filed are Chapter 13 cases. That leaves about 3% for the Chapter 11 cases and 22% for the Chapter 7 straight liquidation cases. Also, I would like to say that we follow under Chapter 13 cases the "good faith" rule, meaning that a debtor should be required to pay as much as he can reasonably afford taking into consideration normal living circumstances.)

Yours truly,

Rufus W. Reynolds
U. S. Bankruptcy Judge

U.S. Department of Justice

United States Trustee
Northern District of Alabama

500 Building, Suite 316
500 South 22nd Street
Birmingham, Alabama 35233

205/254-0047
FTS/229-0047

March 16, 1982

Honorable John LaFalce, Chairman
Subcommittee on General Oversight
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Chairman LaFalce:

This will respond to your letter of March 3, 1982, regarding certain inquiries related to small business filings in bankruptcy.

I think there can be little doubt that the chief factors contributing to the failure of small businesses in the Northern District of Alabama are the tremendous increase of interest on money borrowed as well as the purchase of equipment. The great number of small business failures which were related to the building industry would seem to varify the disastrous effect that high mortgage rates have had on these entities. We see a great deal of poorly managed businesses which could perhaps survive in a good economic environment, but a certain amount of this can be expected. It is simply that some principals of business entities are unable or incapable of making the adjustments necessary for their survival during an economic crunch.

You have asked us to provide you with the types of business concerns that are filing for bankruptcy or reorganization. When I assumed the duties of the administration of cases on October 1, 1979, home construction related businesses were already on a downward trend. These entities included construction, cement, and real estate companies, which in turn, effected retail businesses such as carpet, paint, and furniture stores. Secondly, we began to see a large number of restaurant filings for both reorganization and liquidation. It is obvious the largest factor in these cases were due to the high unemployment in the area. Thirdly, there have been a rather large number of coal companies filing reorganization petitions which are almost invariably later converted to a liquidation. It appears the chief factor here is the high cost of heavy duty equipment necessary for a coal operation, the high cost of wages and fringe benefits, particularly in unionized companies, the high cost of reclamation necessary under state law, and to some extent, poor management in

attempting to mine coal in areas where the overburden (depth necessary to go through before coal is reached), makes it unprofitable. Fourthly, and perhaps the most disturbing, is that in the last year we have seen an increase in the filings of farmers, such as farmers of soybean and poultry, both eggs and fryers. Again, this can probably be attributed to the high interest rates on equipment and the margin of profit, making it difficult, if not impossible, to survive through any protracted bad economic period. Most of the above business entities will begin by filing a Chapter 11 reorganization, however, it soon becomes evident that they are unable to provide the court and creditors with a reorganization plan and usually are converted to a liquidation.

There is one other aspect of small business bankruptcies that you should perhaps be made aware of. To some extent, there is a ripple or domino effect on creditors which are usually also small businesses of the bankrupt business. In this area it becomes increasingly important for the United States Trustee to move for a conversion from a Chapter 11 to a Chapter 7 liquidation when there is no likelihood of the rehabilitation of the business, the extreme hardships on creditors can, to some extent, be alleviated. The United States Trustees must closely monitor a Chapter 11 business to safe guard against continued debts and unpaid taxes which have a priority and therefore can be to the detrement of other unsecured creditors.

Thank you for your inquiries. If I can be of further assistance, please feel free to contact me.

Sincerely,

JACK RIVERS
United States Trustee

BJR/bae

U.S. Department of Justice

United States Trustee
Northern District of Illinois

175 West Jackson Street
Room A1335
Chicago, Illinois 60604

RECEIVED
MAR 26

March 24, 1982

Honorable John J. LaFalce
Chairman
Subcommittee on General Oversight
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Congressman LaFalce:

This responds to your letter of March 3, 1982, concerning small business bankruptcies. In order to respond to your questions, members of my staff have spoken to most of the private trustees presently handling small business cases under the Bankruptcy Code who also served as trustees in cases filed under the former Bankruptcy Act during the 1974-75 recession.

The consensus among the trustees is that the factors behind the current increase in filings and the reasons for filing are identical. They are, basically, the combination of falling sales, difficulties in collecting receivables, high fixed costs that are still rising, and extraordinarily high interest rates.

High fixed costs are cited as the predominant factor in filings by retailers who rented space in shopping malls under leases with escalator clauses. Slow sales are reported as particularly prevalent in businesses that depend, however tangentially, on the health of the automotive, steel, and housing industries. These businesses include manufacturers and retailers of components, accessories, and supplies associated with sales in those industries. In addition, we were informed that small trucking companies were hit hard by the consequences of deregulation, together with the rise in fuel costs.

It seems to be not only traditionally high risk businesses, such as restaurants, those that are undercapitalized, and those that are poorly managed, that are being forced into bankruptcy. Even some well financed, well managed businesses are failing. The consensus among those we interviewed is that the primary difference between bankruptcy filings now and

during 1974-75 is that some businesses that were able to survive low sales during the earlier period of tight money and credit restraints have exercised bad judgment in a period of easy money at high interest rates. Inaccurate projections of increased sales and cash-flow in the near future have led to ruinous decisions to assume short-term debt at present rates and decisions by sellers to deal on open account for long periods in order to stimulate additional sales were shown to be improvident when buyers subsequently filed in bankruptcy. In a small community, or in a small market, one liquidation has a ripple effect throughout the community or the market.

I was particularly interested in the fact that no trustee who had been active in the bankruptcy field for the last decade mentioned the change in bankruptcy legislation as a factor in the recent upsurge in small business bankruptcies. Their focus was entirely on economic conditions. Overall, the trustees were unable to identify any particular trends in filing over that period except for the particular difficulties being experienced by the specific industries mentioned earlier.

I hope this overview from our district will be helpful to the Subcommittee.

Sincerely,

Quinlan J. Shea, Jr.
Acting United States Trustee

U.S. Department of Justice

RECEIVED
MAR 2 6 1982

United States Trustee
Districts of Maine, Massachusetts
New Hampshire and Rhode Island

87 Kilby Street 61
Boston, Massachusetts 02109 FT:

March 25, 1982

Honorable John J. LaFalce
Chairman, Subcommittee on General Oversight
Commiteee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, DC 20515

Dear Chairman LaFalce:

I had been advised by the Executive Office of the United States Trustees to expe a letter from you regarding small business bankruptcies. I looked for this but not receive same and, yesterday, obtained a copy from my colleague, Irving Picar United States Trustee for the Southern District of New York, together with his answer to you of March 18, 1982.

I note that you requested the answers by March 19 so I am getting this off to yo without the benefit of research time.

Although there is a considerable difference between this pilot area and the New rea in terms of major cases, there is not a great deal of variance with respect he filings by small companies. Accordingly, I would generally subscribe to the asons for filings suggested by Mr. Picard--cash flow problems, servicing debts c tinued high interest rates, increasingly slow payments of accounts receivable an the general decline in our economy. Mr. Picard further points out some item whi n really involve poor management and I suggest that prior management practic are of some concern in up to 50% of these cases. However, it amounts to a situa wherein the economic and credit squeeze hits those people first who are the leas prepared.

I have no way of making comparisons between the present and the period prior to new Bankruptcy Code. I have, however, noticed trends even within the past two a one-half years. For example, many small business filings involve a decline in retail sales. Looking at this from the other end, I believe it to be quite obvi that consumers have become increasingly selective as well as price conscious. I more, they are not spending as much money for entertainment and recreational act in this area as in the past, which is well illustrated by the amount of restaur failures.

That brings me to the second question in your letter concerning the types of bu that are filing. In our area, the principal small business entity involves the food and liquor establishments. Beyond this major sector of filings, we see in

nursing home failures which involve the failure of government agencies to make payments to meet current budgets; machine shops engaged in the manufacture of tools, dies, and jewelry related objects; and we also see a number of automobile dealerships, despite the fact that many automobile dealers in this area have simply closed down without seeking relief under the Code.

I regret the hastiness of this letter and would be very happy to make available our files and discuss this further with any member of your staff.

Sincerely,

William Humphrey Tucker
United States Trustee

cc: Quinlan J. Shea, Jr.
Director, EOUST

U.S. Department of Justice

United States Trustee
Districts of Colorado and Kansas

Columbine Building, Room 202 *303/837-5188*
1845 Sherman Street
Denver, Colorado 80203 *FTS/327-5188*

March 16, 1982

MAR

John J. LaFalce, Chairman
Committee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, DC 20515

Dear Congressman LaFalce:

Our observations as to the causes of small business bankruptcies are as follows:

1. Inadequate capitalization
2. Flat or declining sales
3. Mismanagement, usually caused by inexperience
4. High interest rates
5. Ballooning costs due to inflation, especially fuel costs.

In Colorado, restaurants file more Chapter 11 proceedings than any other kind of business, although farmers are rapidly catching up.

In Kansas, truckers lead in Chapter 11 filings.

The recession is affecting all sectors of the economy, and there is not any segment which is immune.

We would be most willing to make our files available to your staff in order that some meaningful statistics could be collected.

Sincerely,

Dolores B. Kopel

Dolores B. Kopel
United States Trustee

cc: Quinlan J. Shea, Jr.
Director, EOUST

George Brody
United States Bankruptcy Judge
United States Bankruptcy Court
For the Eastern District of Michigan
1055 United States Courthouse
Detroit, Michigan 48226

MAR 16 1982

March 12, 1982

The Honorable John J. LaFalce
Chairman, Subcommittee on House
Small Business General Oversight
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman LaFalce:

I have your letter of March 4th asking for my impressions of how the Bankruptcy Act is working out in practice. However, I am not in any position to comment on why there has been an increase in the number of small businesses that are filing for bankruptcy.

I am not an economist, but I assume that the number of filings are, at least in great part, related to the general economy. As you know, unemployment in Michigan has reached dangerous proportions; and what we have, apparently, is a domino effect. I assume also that you have collected all the statistical information that is furnished by the Administrative Office of the U.S. Courts. The review of those statistics should indicate what the trend has been throughout the country.

In 1973, the Commission on the Bankruptcy Laws of the United States issued a Report, which contains two Parts. Part I, Chapter 2 of this Report has an extensive discussion of the causes of bankruptcy. In addition, you might want to examine a book published by The Brookings Institution entitled: Bankruptcy: Problem, Process, Reform by David T. Stanley and Marjorie Girth in which they deal with various aspects of bankruptcy.

Should you be interested in any comments about the Bankruptcy Code generally, do not hesitate to write me.

Sincerely,

George Brody

George Brody
United States Bankruptcy Judge

/sl

U.S. Department of Justice

Executive Office for United States Trustees

Office of the Director

Washington, D.C. 20530

March 29, 1982

Honorable John J. LaFalce
Chairman
Subcommittee on General Oversight
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Congressman LaFalce:

This responds to your letter of March 3, 1982, in which you requested my opinion regarding the reasons for the increasing number of small business bankruptcies. My impressions are, for the most part, based on information provided to me by the various United States Trustees and, accordingly, largely represent a synthesis of their views.

The Trustees' analyses of the situation in the pilot districts suggest that the most important factors contributing to the increase in small business bankruptcies are undercapitalization, declining sales brought on by the current recession and high interest rates. In addition, they indicate that poor management and poor business judgment often lead to bad decisions by small businesses attempting to respond to economic pressures. For example, in an effort to boost lagging sales, small businesses are more likely than large ones to sell on credit to known or suspected credit risks and, in order to avoid losing future orders, to tolerate excessively slow payments by customers. These practices can and do produce sudden acute cash flow problems, particularly for those companies which have already cut their profit margins to the bone. As soon as suppliers suspect that cash flow problems exist, they may well exacerbate a situation by requiring C.O.D. payment as the price of shipments. Current high interest rates may effectively prohibit a company from borrowing to refinance its operations, even if its accounts receivable are still considered adequate security by a potential lender. Finding an investor willing to provide new capital on acceptable terms has become increasingly difficult given the more secure investments otherwise available. To some extent, the removal of the social stigma once associated with bankruptcy, media coverage which suggests bankruptcy as a popular and acceptable approach to solving difficult financial problems, and an increase in advertising by lawyers specializing in bankruptcy are factors affecting the proliferation of bankruptcy filings.

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At the present time, the incidence of bankruptcy seems most prevalent in the restaurant trade and in real estate related industries, particularly construction. Economic problems encountered by businesses in this latter category significantly affect the well-being of such related retail operations as furniture and hardware stores. Examples of regional variations include, in the Midwest and South, a recent substantial increase in the number of farmers filing in bankruptcy, while on the West Coast, filings by entertainment related businesses are common.

Because the U.S. Trustee program was not in existence during the 1974-75 recession, I can offer little assistance in comparing that period with the current situation. It does appear, however, that small businesses in the previous recession were not faced with the added burden imposed by high interest rates and that this single factor has made the difference in many cases between survival then and failure now.

Sincerely,

Quinlan J. Shea, Jr.
Director and Counsel

U.S. Department of Justice

United States Trustee
Districts of the District of Columbia and
Eastern Virginia

421 King Street, Suite 410
Alexandria, Virginia 22314

703/557-0746
FTS/557-0746

March 17, 1982

The Honorable John J. LaFalce
Chairman
Committee of Small Business
Subcommittee on General Oversight
United States House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman LaFalce:

This is in response to your letter of March 4, 1982, regarding small business filings under the Bankruptcy Code in the District of Columbia and the Eastern District of Virginia.

As you know, the United States Trustee program began in October, 1979. In the preceding year, 1978, there was a total of 213 filings under the Bankruptcy Act in the District of Columbia (including 3 Chapter XI cases) and 4,319 filings (including 13 Chapter XI cases) in the Eastern District of Virginia. I do not have available a breakdown of the small businesses involved in these filings or other comparative information for earlier years.

In calendar years 1980 and 1981, filings under the Bankruptcy Code in the District of Columbia and the Eastern District of Virginia were as follows:

1980 District of Columbia		1980 Eastern District of Virginia	
Total filings	601	Total filings	5,828
Chapter 11	25	Chapter 11	61

1981 District of Columbia		1981 Eastern District of Virginia	
Total filings	719	Total filings	5,943
Chapter 11	55	Chapter 11	109

and creditors of small retail businesses frequently cite the high cost of financing inventory (often prime plus two to four points) and a reduction in the rate of consumer purchases.

Two other important factors should be noted. First, many businesses are initially undercapitalized. They thus lack adequate resources to meet a temporary change in the rate of consumer purchases or increased costs. Secondly, businesses sometimes fail because of consistently poor management or because of a single serious error in business judgment. There is little hope for businesses where management is not properly trained or when the business is clearly undercapitalized. In a period of declining sales or increased costs with slim profit margins, the margin of error for business judgments is substantially reduced and businesses which might otherwise continue to prosper, encounter serious financial difficulties.

You will note from the statistics, there has been a substantial increase in the number of businesses seeking rehabilitation under Chapter 11 of the Bankruptcy Code. For most of these businesses, reorganization will not be feasible and in most situations, the businesses will be liquidated under Chapter 7 of the Bankruptcy Code. A significant number, however, do result in confirmed plans which enable the debtor to remain in business, retain its employees, and to make a substantial payment to many of its creditors. More than one-half of the professional staff time of this office is devoted to supervision of the management of debtors in possession or of trustees operating these businesses during the period of reorganization. In almost all of the cases involving a successful reorganization, there are substantial changes in the manner in which business operations are conducted. These changes are aimed at increasing sales, and in lowering costs. In addition, successful reorganizations frequently involve a sale of all or a part of the business operations and/or infusions of additional capital.

I hope the foregoing information will be of some help. I will be happy to answer any further questions which you may have in this area.

Sincerely,

Francis P. Dicello
United States Trustee

FPD:bls

Attachments

34 Chapter 11s filed during 198

1980 CHAPTER 11s - ALEXANDRIA

CASE NUMBER	DEBTOR	TYPE OF BUSINESS	ASSETS	LIABILITIES
80-00011	Mr. Sunshine Decorators, Inc.	decorators	5,832.00	23,539.12
80-00020 80-00047 80-00048 80-00049	Vecco Concrete Construction Co. of VA) Vecco Concrete Construction Co. of DC) Vecco Concrete Construction of MD) Vecco Service Co.)	concrete construction		
80-00072	Pinewood Enterprises	holding & disposing of real property	2,890,977.93	3,312,418.30
80-00180	Virginia Hermetics Corporation	mfg. and distribution of motor parts	132,506.21	112,403.51
80-00181	Industrial, Commercial & Mechanical Services	heating & air conditioning installation, service, maintenance	611,902.02	543,148.08
80-00256	Andrew M. Shields Corporation	real estate investment		
80-00321	Wine Cellar Club, Inc.	restaurant	232,033.83	169,097.37
80-00323	T. I. Schwartz Clothier	retail clothing	1,430,816.00	913,396.33
80-00353	Arone Publications, Inc.	publications	97,292.37	222,764.31
80-00493	Northern Va. Ambulance, Inc.	ambulance service	149,737.50	181,579.40
80-00600	CSL Mortgage (Corp.)		190,282.33	604,724.44
80-00692	Meloy Inc. t/a Bar Mart	retail store	327,818.84	681,778.15
80-00700	Marketplace Organization, Ltd.	telephone soliciting	19,014.79	289,660.25
80-00701	B&K Studios, Inc.	graphic arts, advertising	36,885.76	79,220.02
80-00717	Dick Blanken Ford, Inc.	auto retail	3,620,579.30	3,545,830.98
80-00752	Cavo D'Oro (Corp.)	restaurant	27,500.00	106,797.68
80-00822	Harksalon, N.V.	hair dresser	18,517.50	232,642.31
80-00945	Metro Mfg. Co., Inc.	furniture mfg.	600,832.50	1,031,277.75
80-01076	Carrier Telephone Co. of America, Inc.	communications	318,295.78	4,294,886.65
80-01093	Metro Mfg. Co. of Texas	furniture mfg.	143,552.30	508,070.32
80-01094	Metro Retailing of Texas, Inc.	furniture retail	100,137.00	556,463.00

Exhibit 1

1980 Chapter 11s - Alexandria (continued)

CASE NUMBER	DEBTOR	TYPE OF BUSINESS	ASSETS	LIABILITIES
80-01105	Design Craft Ltd.	home remodeling	43,216.46	122,129.06
80-01239	NOVA Real Estate Investment Trust		31,243,180.00	17,498,907.00
80-01288	Stafford Water Corporation	public water corp.	392,214.85	485,980.01
80-01289	Stafford Service Corporation	public sewerage utility	412,569.14	507,802.72
80-01290	Staffordboro Enterprises	mobile home park	5,162,155.79	1,632,035.20
80-01317	Donnald Sonner d/b/a Blackbeard's Seafood	restaurant	1,532,500.65	283,032.93
80-01352	Paul-Ray, Inc. t/a Wolff's	men & boys retail clothing	170,998.33	664,712.56
80-01367	Roberts DeLaTore Partnership	real estate investment	324,000.00	347,075.00
80-01392	Century Aviation (corp.)	airplane retail and training	85,848.90	270,004.12
80-01428	Mecklinburg Enterprises, Inc. t/a Carousel Restaurant	restaurant	100,000.00	391,317.00

1981 CHAPTER 11s - ALEXANDRIA

CASE NUMBER	DEBTOR	TYPE OF BUSINESS	ASSETS	LIABILITIES
81-00016	Emay, Inc.	management consultant	403,655.40	664,683.91
81-00021	Fox Hill Restaurant, Inc. d/b/a Caruso Ristorante	restaurant	183,820.00	271,775.13
81-00040	Master Craft Products	retail trophies	51,058.07	153,779.12
81-00058	Media Solutions Corp.	graphic arts	52,278.01	151,670.07
81-00130	Dawson Green Builders	construction (gen'l contractor)	242,582.93	195,904.07
81-00141	Burley Associates Limited Partnership	ownership of property	676,842.17	632,186.62
81-00145	B. W. Streeter	fast foods	1,714,485.00	945,062.09
81-00182	Cafe Group Auburn Limited	fast foods	891,251.42	1,152,573.80
81-00285	A-Citywide Cooling & Heating Co., Inc.	installation of furnaces & air conditioners	136,357.18	186,283.67
81-00302	Service Station Enterprises	gasoline station	NOT AVAILABLE	
81-04105	APT Insulation	insulation contracting business	36,293.00	127,431.39
81-00307	E-Z Cruz	marine sales & service	597,270.00	918,988.74
81-00323	James L. Corbitt, Inc.	home construction	1,605,940.00	5,332,375.80
81-00381	Morris D. Fox t/a Fox-Dell Farm		115,315.00	411,923.11
81-00385	Community Investments Associates, a Limited Partnership	building single family homes	2,500,000.00	783,716.33
81-00429	Fox's Transport (corp.)	trucking	189,000.00	318,275.33
81-00440	Mid-Atlantic Contracting & Equipment Corporation	construction & heavy equipment	381,443.59	267,049.67
81-00507	International Data Systems			
81-00608	Keyboards America, Inc. t/a Campbell's Music	retail sales of pianos, organs and accessories	2,752,999.91	1,522,670.34
81-00610	Streeter of Allentown	fast foods restaurant		

Exhibit B

1981 Chapter 11s - Alexandria (continued)

CASE NUMBER	DEBTOR	TYPE OF BUSINESS	ASSETS	LIABILITIES
81-00620	National Capital Developers (partnership)	real estate	9,776,000.00	9,651.433.65
81-00627	Hamilton B. Woodson t/a Ham's Crane	towing service	219,460.00	114,594.22
81-00699	Linda M. Comer t/a Bilinda Kennels	dog kennel	131,500.00	68,400.00
81-00780	Satisfaction, Inc.	retail clothing	313,828.00	1,066,770.17
81-00786	Bond Office Services	mailing services	521,585.66	424,928.18
81-00794	Drake Thermal Genie Corp.	heating & air conditioning construction	1,302,269.85	739,280.22
81-00890	Loudoun Heights Construction	real estate	433,000.00	270,689.68
81-00923	Monandel, Inc., a VA Corporation	production & distribution of children's programs	283,258.68	255,451.03
81-00925	Children's Television Int'l, Inc.	trucking	NOT IN FILE	
81-00936	Jay's Trucking Company	real estate investment	1,800,000.00	1,312,000.00
81-00981	Tirupati Associates Limited Partnership	retail billiards products	276,349.16	366,864.31
81-01006	A&D Billiards, Inc.	retail eyeglasses	150,000.00	280,013.41
81-01034	B. J. Odom Opticians	cab co.	3,770.00	229,624.20
81-01044	Springfield Yellow Cab	holding company	212,756.63	278,656.94
81-01045	Lloyds of VA	taxi company	2,400.00	86,281.55
81-01046	Reston Herndon Transport	installation of floorings	146,999.54	259,037.99
81-01071	Sterling Floors, Inc.	excavation	109,493.39	290,870.37
81-01207	Smoot Excavating	excavating	326,500.00	176,389.81
81-01223	Rappahannock Grading & Utilities, Inc.	trucking	4,069.00	35,548.75
81-01234	Percy Benton t/a Benton Trucking	product development and sale of electronic products	537,310.98	493,906.22
81-01269	American Computer & Telecommunications Corporation	mfg. and retail of windows and doors	519,770.00	936,016.17
81-01299	Dominion Sash & Door			

1981 Chapter 11s - Alexandria (continued)

CASE NUMBER	DEBTOR	TYPE OF BUSINESS	ASSETS	LIABILITIES
81-01310	I.L.S. d/b/a Alexander's Three Penthouse Restaurant	restaurant (gen'l purpose charter)	168,540.21	388,671.32
81-01377	Musolino & Sons	gasoline station & motel	1,032,379.00	438,205.70
81-01426	Commonwealth Publishing Company, Inc. (INVOLUNTARY)		NOT AVAILABLE	
81-01440	W. T. Horseman Excavating	contractor	627,280.00	733,386.23
81-01452	The Market Place of Virginia	retail grocery	64,989.00	246,941.98
81-01459	S&C Printing	printing	540,175.00	657,456.00
81-01478	Dorsey-Bryant, Inc.	heating & air conditioning contractors	22,369.00	138,843.14
81-01487	Azalea Acres Partnership	real estate	461,000.00	610,000.00
81-01507	Sacra Construction, Inc.	construction	3,693.00	457,471.71

(50)

CHAPTER 7 BUSINESS CASES
ALEXANDRIA DIVISION
1980

Case #	Case Name	Type Business	Assets	Liabilities
80-00013	Fair City Florist, Inc.	florist	$ 14,640	$ 211,586
80-00043	Internat. Steel Fabric. Corp.	construction	12,500	1,945,625
80-00044	Sportscraft, Inc.	car sale/repair	220,440	249,616
80-00072	Pinewood Enterprises	construction	2,890,977	3,312,418
80-00075	Skeeter's Saddlery, Inc.	retail tack/bridle	265	10,527
80-00095	*t/a Comprehensive Mktg. Co.	marketing	---	---
	*t/a Metro Discount Club	marketing		
80-00220	Ultra-Market, Inc.	grocery (frozen)	92,200	144,578
80-00224	Atoka Agriculture Sys., Inc.	farming	94,455	391,973
80-00276	*t/a Laine Construction	construction	16,917	94,311
80-00299	*t/a Eagle Glass & Screen Shop	remodeling	40,455	90,154
80-00318	The Kitchen Shoppe of Alex.	remodeling	115,181	261,143
80-00372	The Mixed Bag, Ltd.	retail gift	30,234	253,639
80-00462	*t/a Va. Pool & Excavation Co.	construction	22,065	52,343
	*t/a McGaha Lawn Service	landscaping		
80-00524	*t/a Culpeper Packing Co.	butcher	144,383	141,738
	*t/a Smoot's Slaughter House	butcher		
80-00540	Messers Metal Products, Inc.	metal fabricating	54,112	74,705
80-00545	Cardinal Chrysler Dodge	automotive sales	431,903	197,287
80-00586	Duct Man, Inc.	construction	3,580	14,899
80-00602	Kent's Mens Wear	retail clothing	4,751	32,666
80-00605	Acro Van Lines, Inc.	trucking	725	88,834
80-00616	Interstate Concrete & Construction Co., Inc.	construction	20,000	136,353
80-00673	Rosenberg's Shoe Place	retail shoes	10,375	66,724
80-00639	*f/t/a D & G Construction	construction	81,744	116,013
80-00642	Fairview Corporation	construction	65,969	695,849
80-00659	University Meats, Inc.	butcher	20,585	56,945
80-00676	*f/d/b/a Bachelors II	nightclub	136,109	347,536
80-00677	*f/d/b/a Bachelors II	nightclub	66,250	145,993
80-00686	FAA Flying Club	plane rental/ flying lessons		
80-00743	d/b/a Commonwealth Christian School	private school	580,000	729,675

*Indicates individual(s) trading or formerly trading or doing business under given name.

Exhibit C

Case #	Case Name	Type Business	Assets	Liabilities
80-00808	*f/d/b/a North American Mortgage Co., Inc. *f/d/b/a Town House Sq.Assoc. *f/d/b/a DDF Assoc.	mortgage company	111,461	271,535
80-00832	Loudoun Plumbing & Heating Inc.	plumbing/heating	21,539	201,505
80-00884	Howie's Home Improv., Inc.	remodeling	3,222	29,406
80-00921	*t/a B & E Decorators	painting	406	30,996
80-00966	Snapp Associates, Inc.	retail tools	5,000	284,596
80-00974	*t/a James Michael Constr. Co.	construction	936	10,295
80-01019	*f/d/b/a Carriage House Furn.	retail furniture	599,55[illegible]	878,536
80-01077	*t/a Ledbetter Painting	painting	1,[illegible]	12,392
80-01162	Mickey's Auto Care & Repair	automotive repair	9,[illegible]	26,545
80-01215	*t/a Modern Office Supplies	office supply	0	114,000
80-01236	Jennings/Larson Ltd.	graphics	54,015	219,240
80-01238	Sheet Metal Fabricators Inc.	construction	67,536	252,565
80-01270	*d/b/a Guy M. Thrift, CPA	accountant	5,083	31,653
80-01273	*t/a Glenn's Lawn & Garden Equip.	retail yard equip.	201,450	477,607
80-01293	Parker Sporting Goods, Inc.	retail sports goods	***	***
80-01345	C.B. Strickland, Inc.	electrician	45,701	211,613
80-01350	*f/d/b/a Boothbay Properties *f/d/b/a Bradley House *f/d/b/a Clipper Inn	real estate developer	13,628	172,448
80-01351	*d/b/a Paul's Shoe Box, Inc.	retail shoes	3,440	10,307
80-01379	*t/a Imperial Home Improvements	remodeling	3,265	7,515
80-01401	*f/t/a Lillard Trucking *f/t/a D & L Trucking	trucking	71,382	75,426
80-01437	*t/a Community Roofing & Sheet Metal Contractor	construction	3,300	40,090
80-01448	Park Brothers Moving Corp.	moving	201,265	408,630

***Schedules of assets and liabilities were never filed in this case; it was subsequently dismissed.

(101)

CHAPTER 7 BUSINESS CASES
ALEXANDRIA DIVISION
1981

Case #	Case Name	Type Business	Assets	Liabilities
81-00008	Transputer Corporation	court reporting	12,650	177,102
81-00016	Emay, Inc. (transfer from D.C.)	management consult.	403,655	664,684
81-00060	Potomac Stationery	retail stationery	6,543	10,860
81-00076	*t/a Reston Montessori Sch.	private school	1,240	15,256
81-00080	*f/t/a C.J. & Son	construction	9,017	32,215
81-00085	Portfolio Commercial Art & Graphics, Inc.	graphics	97,900	263,655
81-00086	Potomac Company, Inc.	construction	131,080	145,247
81-00094	*t/a Naito's Fencing	fence installer	44,900	78,588
81-00131	*t/a Megellan's Florist	florist	2,915	48,752
81-00140	*d/b/a Books America *d/b/a Caesar Books	book publisher book sales	---	---
81-00146	*d/b/a Old Town Taxi Co.	independent taxi	1,965	12,700
81-00165	*t/a Paul A. Hall Plumbing	plumbing	69,880	157,029
81-00178	Fisher & McCoy, Inc.	construction	320	46,357
81-00201	*t/a Alexandria Dr.'s Office *t/a Doctors Office Services	medical services medical services	64,495	206,333
81-00202	Mobile Medics Assoc., Inc.	medical services	3,062	49,343
81-00221	The Energy Mgmt. Center, Inc.	heating & a/c	4,700	196,024
81-00225	C & H Office Supply, Inc.	office supply	70,069	104,614
81-00244	*t/a Hunt's Towing Service	towing service	79,641	139,526
81-00263	*f/d/b/a Anthony Personnel Inc.	employment agency	9,192	99,399
81-00331	*d/b/a Cawthon's Custom Typing Service	typing service	3,883	15,633
81-00348	*f/t/a Landmark Flowers *f/t/a The Welcome Inn *f/t/a The Skyline Patio *f/t/a Omara, Inc. *f/t/a Magic Carpet *f/t/a Muscho, Inc.	assorted unsuccessful small businesses	0	44,198
81-00354	*t/a Burger Inn	restaurant	0	4,454,845
81-00355	Paul's Shoe Box, Inc.	retail shoes	3,440	10,306
81-00357	*d/b/a Kapture Company	employment agency	2,020	33,188

*indicates individual(s) trading or formerly trading or doing business under given name.

Case #	Case Name	Type Business	Assets	Liabilities
81-00422	Point One Design, Inc.	graphic arts	3,693	88,366
81-00443	*f/t/a Monmouth Environmental Assoc.	heating & a/c	74,068	133,359
81-00525	*f/d/b/a King Lamps	retail lamps	6,069	79,674
81-00540	*f/d/b/a Good Life Home Improv.	construction/ remodeling	55,836	77,214
	*f/d/b/a Par & Sons Builders			
81-00568	*f/d/b/a Henry D. Iddings, Jr. Trucking	trucking	91,256	150,438
81-00598	Law Offices, Paul D. Scanlon, Ltd.	attorney	11,376	151,287
81-00606	Minuteman Supply & Equip. Co.	restaurant supply	97,260	142,794
81-00612	*t/a Oak Construction Co.	construction	76,747	188,686
81-00630	Medal Electric Co.	electrician	394,692	140,000
81-00631	*f/t/a B & M Construction Co.	construction	8,166	47,237
81-00635	*f/t/a B & M Construction Co.	construction	94,367	142,686
81-00644	Dave's Heating & Air Cond. Inc.	heating & a/c	0	79,458
81-00645	*f/d/b/a Land America, Inc.	advertising/ real estate/ promoter	2,206	1,065,995
81-00710	*f/d/b/a Harry Miller Trucking	trucking	41,889	46,658
81-00720	*f/t/a Statewide Constr. Co.	construction	4,511	15,923
81-00731	Commonwealth Plumbing & Heating Co.	plumbing & heating	70	131,425
81-00754	*t/a L.S. Mitchell Constr.	construction	126,054	50, 90
81-00758	*f/t/a Sahara Restaurant	restaurant	14,810	82,866
	*f/t/a Ali Baba Restaurant	restaurant		
81-00759	*f/t/a Colonial Coffee Shoppe	restaurant	3,060	10,360
81-00761	*f/d/b/a Renegade Construction	construction	29,490	270,098
	*f/d/b/a Larry Sams Concrete	concrete		
81-00762	*f/d/b/a Renegade Construction	construction	29,765	202,602
	*f/d/b/a Superior Concrete Inc.	concrete		
81-00787	*f/d/b/a Special Interest Restoration	restoration	162,508	178,781
	*f/d/b/a RIS	restoration		
81-00796	Strawberry Fields, Ltd.	farming/produce	355,919	778,602
81-00799	*f/t/a Catlett Service Center	gas station	85,411	96,529
81-00851	Transpo, Inc. (USA)	air freight	0	79,228

Case #	Case Name	Type Business	Assets	Liabilities
81-00877	Diversified Direct, Inc.	mailing service	229,975	666,810
81-00916	*t/a Abbey Oaks Joint Venture	construction	1,290,000	1,279,685
81-00917	Grady Tile & Floor Covering Inc.	tile/carpet	***	***
81-00941	*t/a United Tours	travel service	1,330	451,904
	*t/a Carpet Connection	carpet		
	*t/a Rugs Unlimited	carpet		
81-00964	Red Carpet Fran Smith & Assoc. Inc.	real estate	21,040	240,065
81-01005	Loudoun Machine Works, Inc.	machinist	19,400	28,760
81-01051	Monroe-Beard Assoc., Inc.	advertising	4,432	48,968
81-01056	Brouse's Glass Co., Inc.	glazier	440,524	431,122
81-01061				
81-01082	Red Barn Tractor & Equipment, Inc.	tractor/equip. sales	47,650	363,633
81-01101	*t/a Ron Wiencek Contracting Co.	remodeling	0	26,262
81-01116	O'Donnell, Brian & Karen	attorney	26,000	22,911
81-01117	*f/t/a Jack's Auto Body	automotive repair	7,222	22,759
81-01128	*f/t/a Michael D. Carpenter, Plumbing & Electric	plumbing/ electrician	9,323	56,861
81-01136	*t/a Designers Way	interior decorator	6,605	40,274
81-01138	*f/d/b/a Shenandoah Kitchens	remodeling	13,610	142,696
	*f/d/b/a Peaks Unlimited	remodeling		
81-01143	Arcum Pharmaceutical Corp. d/b/a Raymond Printing	pharmacy/ printing co.	14,883	72,188
81-01144	*f/d/b/a Springfield Sheetmetal	construction	129,751	388,503
81-01150	*t/a Billy M. Owen, Inc.	firearms dealer	306,488	351,070
81-01156	KVM Construction Co., Inc.	construction	3,060	78,772
81-01167	*t/a Maxwell Masontry Contr.	masonry	328,288	283,788
81-01203	Pruitt Upholstering & Manufacturing Co., Inc.	furniture repair & manufacture	160,845	501,577
81-01208	*d/b/a Honeysuckle Rose	retail clothing	13,476	83,994
	*d/b/a attorney	attorney		
81-01219	*t/a Mellott Construction	construction	113,000	178,500
81-01238	*d/b/a 3-J Company	real estate	84,743	207,585
81-01239	Nationwide Home Security Systems Inc. of Va.	home security systems	6,006	41,097

***Schedules of assets and liabilities were never filed in this case; it was subsequently transferred to another district.

Case #	Case Name	Type Business	Assets	Liabilities
81-01240	Chandlers, Inc.	public relations	0	184,224
81-01241	Remarkable Media Assoc. Inc.	public relations	0	184,224
81-01246	*t/a The Fire Box	wood stove sales	81,600	23,486
81-01247	Dyal Moving & Storage Co.	moving company	0	79,628
81-01283	Ro-Fan, Inc.	beauty salon	4,487	35,591
81-01285	*t/a Alexandria Roofing Co.	roofing	5,235	21,492
81-01307	*t/a American Federal Constr.	construction	365,000	477,628
	*t/a Turpen & Assoc.	construction		
81-01311	*t/a The Water Closet	retail linens	8,866	42,623
81-01318	*t/a Carl Gray Painting	painting	3,780	798
81-01327	*t/a The Breaking In Company	talent agency	7,371	46,807
81-01336	*t/a Finally Mine, Inc.	retail sales	1,170	130,585
81-01348	*t/a Chris' Trash Service	trash collection	4,970	112,100
81-01357	*t/a The Fire Box	wood stove sales	3,050	24,377
81-01371	(partner, B & G Investment)	investment company	356,348	7,277,852
81-01372	*f/d/b/a Yanick Plumbing & Heating	plumbing/heating	4,344	36,794
	*f/d/b/a Prince Wm. Plumbing			
81-01407	Pachyderm Corporation (a/k/a L'Elephant Blanc)	retail housewares & gifts	7,540	57,227
81-01414	*t/a Bug & Honda Shop	car repair	5,847	222,062
	*t/a Daren Corp. (Paradise Nite Club)	nightclub		
	*t/a Tidy Maid Service	maid service		
81-01425	*t/a Evan Fredericks & Assoc.	executive search consult.	2,823	17,797
81-01428	*t/a Mountain Valley Farm	farming	169,704	536,711
81-01429	*t/a Mountain Valley Farm	farming	162,414	536,711
81-01431	*f/d/b/a Keynote Distributors	piano teacher	3,897	4,639
81-01461	Walside Development, Inc.	remodeling	75,000	1,996,894
81-01462	Vynaseal International Corp.	remodeling supplies	597,713	1,062,750
81-01466	former operator, Sunrise Egg Farm	poultry products	230,448	551,585
81-01512	Rockwell Sales Co., Inc.		0	20,436
81-01513	Executive Associates, Inc.	employment agency	895	16,671

U.S. Department of Justice

United States Trustee
Districts of the District of Columbia and
Eastern Virginia

421 King Street, Suite 410
Alexandria, Virginia 22314

703/557-
FTS/557-

March 23, 1982

MAR 24 '82

The Honorable John J. LaFalce
Chairman, Committee of Small Business
Subcommittee on General Oversight
United States House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman LaFalce:

In reviewing my letter to you of March 17, 1982, regarding small business filings in the District of Columbia and the Eastern District of Virginia, I have noted an error on page one of that letter. In 1978, according to information which I have available, there were 44 Chapter XI cases filed in the Eastern District of Virginia.

I apologize for the inconvenience.

Sincerely,

Francis P. Dicello
United States Trustee

FPD:bls

ECONOMIC POLICY AND BUSINESS LIQUIDITY by Allen Sinai*

Business liquidity is in the worst shape of the postwar period, primarily the consequence of economic policies designed to end the severe double-digit inflation of the 1970s. Three years of recessions characterized by unprecedented high levels of nominal and real interest rates, a severe squeeze on profits, record high debt service burdens, new peaks for short-term debt relative to total indebtedness, and increased leverage have combined to create a precarious situation for U.S. corporations. The number of industries and businesses at risk in the current environment are without precedent in the postwar period, as are the number of depressed sectors, industries, and areas of the country and the number of firms with severely deteriorated financial positions. This situation, together with still extraordinarily high levels of interest rates in an economy not yet out of recession, and with the current track of fiscal and monetary policy, threatens to prevent a meaningful and sustainable economic recovery. Indeed, without changes in the current thrust of economic policy, an unprecedented liquidity crisis for the U.S. business sector is a real risk. And regardless of the outcome of the current episode, American business will undergo a major shakeout, with implications for the structure and thrust of corporate activities for many years to come.

What is the extent of the deterioration in business balance sheets and liquidity? Why has the financial health of U.S. corporations worsened so much? What is the risk to the economic recovery from the damage that has been done to business balance sheets? How much at risk are nonfinancial corporations and financial institutions in the current economic environment? What changes in policies might arrest the progressive deterioration of business liquidity and restore the balance sheet strength necessary to support a sustained recovery? This study is concerned with these issues.

In brief:

- Business balance sheets and corporate liquidity are more fragile than at any other time in the postwar period. The debt service burden of nonfinancial corporations, defined as the proportion of estimated interest charges on outstanding indebtedness relative to cash flow, was 46.7% in 1982:1, up from the most recent low of 24.5% in 1977:3. The previous peak was 44.9% in 1974:3. The ratio of short-term to total debt is 42.5%, a new high, reflecting the inability of corporations to restructure debt to a longer maturity in the current interest rate environment. The "quick" ratio for the nonfinancial corporate sector, defined as the ratio of financial assets to short-term liabilities, was 37.7% in the first quarter of 1982, a new postwar low. Corporate leverage has risen to new highs, the result both of huge rises in short-term bank borrowing over the past year and a half and the worst squeeze on profits in the postwar period.

The worsening of business liquidity is the consequence of a set of business cycle downturns since 1980 on a scale unprecedented for the postwar period. Three years of recessions, with only a brief expansion wedged in between, and restrictive macroeconomic policies have depressed corporate profits and cash flow far below the levels of 1979 and, in real terms, back to the levels of the late 1970s. The New Fed Policy and prospects of huge federal budget deficits have caused record high levels of nominal and real interest rates, raising interest expense and contributing to the inability of corporations to restructure debt maturities to a longer term. The combination of weak cash flow, heavy use of short-term debt, large amounts of outstanding long-term debt, and interest rates sustained higher for longer than ever before, is the reason for the current squeeze on the U.S. business sector.

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*Based on testimony before the Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs, House of Representatives, May 27, 1982. The full testimony is available upon request. The assistance of Carol Zahka and Fred Plemenos is gratefully acknowledged.

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Economic Policy and Business Liquidity

. A large potential casualty list of industries and firms has been the side effect of a tough macroeconomic policy approach to eliminating excess inflation. The list includes: agriculture, agricultural machinery, air transport, aluminum, autos, building materials, chemicals, copper, forest products, lead and zinc, miscellaneous metals and mining, real estate and homebuilding, retailers, steel, and trucking. Whole sectors of the economy such as small business, thrifts, and state and local government are "at risk," that is, in a situation where severe pressure on cash flow threatens highly leveraged companies, weakening balance sheet ratios and making earnings especially vulnerable to lower sales. Firms at risk may also have difficulty raising funds through borrowing or by selling debt issues to sustain operations. A forced liquidation of assets can result.

. The deterioration in business balance sheets and liquidity is having serious effects on the U.S. economy, intensifying the current recession and threatening to delay a sustainable recovery. Corporate America is in the process of sweeping cutbacks in order to conserve cash, maintain existing operations, and preserve financial viability. Large reductions of inventories, postponement or cancellation of expenditures on plant and equipment, and the elimination of excess capacity are characteristic of many industries. Massive layoffs are in process, with double-digit unemployment rates now in 19 states compared with eight states in May 1975, the month of peak unemployment in the severe recession of 1974-75. Complete lines of business are being sold in many instances to raise cash. This squeeze on business balance sheets late in recession is not a new phenomenon, having occurred in all previous postwar recessions. What is new is the extent of the progressive deterioration that has occurred over the last few years, and the disturbing lack of any prospect for the sharp reversal that usually occurs.

. A sustained economic recovery cannot take place unless the business sector can fully reliquefy balance sheets. Missing so far from the current recession is the reliquefication that has typified every flow-of-funds cycle since 1955. In this process, businesses cut back on outlays for inventories and capital, reduce borrowing and repay debts, lower employment, rebuild the asset side of the balance sheet, reduce debt service and repayment burdens, restructure liabilities, and decrease leverage. The onset of reliquefication usually comes about two quarters before the end of a recession. So far, only a brief reliquefication has occurred, lasting from 1980:2 to 1980:3, and this was aborted by the expansion of late 1980 and early 1981. A new reliquefication may have started in the first quarter of this year, but if so, it is a long way from completion.

. Already, a record number of bankruptcies and failures for the postwar period are occurring for both nonfinancial corporations and financial institutions. Major corporations that have failed include A.M. International, Braniff, Brentano's, Fidelity Savings and Loan, Intel, J.W. Mays, Saxon, Spector Red Ball, and Wickes Cos. Approximately 5% of the top 1,000 U.S. corporations are likely to be at varying degress of risk in the current environment, with scores of other, smaller businesses potential casualties. A record of 87 thrift institutions were merged in the first quarter, aided skillfully by the regulators, at a cost of well over $1 billion. There have been 11 failures of commercial banks this year, the most since 1976. Total bankruptcies this year, as recorded by Dun and Bradstreet, are 9,057 to date—headed toward a new postwar record. The business failure rate, while sharply higher at 80 per 10,000 organizations currently is still well below the 154 per 10,000 rate of 1932.

. Most certainly, additional well-known companies will fail even after the recession ends, in the aftermath of the current episode and before healthy financial underpinnings are restored in the corporate sector. The reliquefication process for business typically lasts four to eight quarters, and it is during reliquefication that most failures occur. Dating the current reliquefication for business as having begun in 1982:1, there is still about a year to go before business financial conditions will be substantially improved.

. The current mix of economic policy constitutes a major threat to the ability of the business sector to regain financial health. The current "loose fiscal-tight money" approach of the Reagan Administration and the central bank guarantees sustained high interest rates and depressed conditions for the interest rate sensitive areas of the U.S. economy. Under the New Fed Policy, any recovery will be accompanied by upward pressures on interest

rates, since increased demands for funds are automatically translated to interest rates. The squeeze on business liquidity cannot ease quickly under this policy scenario. Capital goods outlays also are threatened by this policy mix, with the effects of Reaganomics and the New Fed Policy turning out to be counterproductive for capital formation instead of supportive, as intended.

. A better policy choice would be a "tighter fiscal-easier money" mix, which would lead to large declines of interest rates and aid revival of the sectors, industries, and firms that have been severely damaged by the liquidity squeeze of the last few years.[1] Without substantial declines of interest rates, it will be difficult for nonfinancial corporations to reliquefy balance sheets sufficiently for a sustained recovery. The pressure on interest rate sensitive industries that has been in place since 1979 must be relieved before a more typical reliquefication can occur.

THE ECONOMY, ECONOMIC POLICY, AND CORPORATE LIQUIDITY

The U.S. economy is currently in recession, by now quite deep. Moreover, this is the third consecutive year in which a downturn has taken place. The recession experience of the past three years has been atypical. The pattern of the business cycle appears to have been altered, with shorter and more volatile fluctuations in the economy and financial markets. Since 1979, there have been two recessions and one expansion. The upswing lasted only 12 months, the shortest of the postwar period. So far in this leg of the series of downturns that began in 1980, most aggregate statistics show a somewhat worse than average recession experience. But viewed over a longer time horizon, the downturn since 1980 is unprecedented for the postwar period. Since the peak of the expansion in January 1980, real GNP has dropped 1.3%, industrial production is down 7.9%, the unemployment rate has risen from 6.2% to 9.4%, the capacity utilization rate for all manufacturing has dropped to 71.1% from 83.6%, and the "gap" between potential and real output is a huge $166.7 billion. Of the last 28 months, 17 have seen an economy in recession.

The anomalies of the current episode include:

. A "double-dip" recession episode that began with a short, sharp downturn from January to July 1980, interrupted by a brief expansion between July 1980 and July 1981, followed by another slide that started last summer. The series of cycles since 1979 have produced recessions in each of the last three years--1980, 1981, and 1982. Not since the Great Depression has there been three consecutive years of downturns.

. Restrictive economic policies. Always in previous recessions, monetary policy has been eased to reduce nominal interest rates and stimulate recovery. Fiscal stimulus usually is applied as well, typically through increased spending and sometimes from lower taxes. But since mid-1979, monetary policy has been exceptionally tight, with only a few brief interruptions. Indeed, the Federal Reserve tightened early this year, even when real GNP was declining at a 4.3% annual rate, raising short- and long-term interest rates by 50 to 200 basis points. And the fiscal stimulus of Reaganomics did not really begin until October 1981, with most of it programmed to occur in future years.

. Extraordinarily high nominal, real, and real aftertax interest rates, far above the levels of previous postwar downturns. At the present time, far into the current recession, nominal interest rates are not much below previous peak levels. In real aftertax terms, short-term interest rates are higher now than before the recession began (Chart 1). In the case of long-term bond yields, the real rate of interest is the highest it has been in this century (Chart 2).

. An incomplete restructuring of balance sheets. Households, businesses, and depository institutions have not yet fully reliquefied financial positions. Full-scale reliquefication always has been a necessary ingredient for sustained recovery.

. An unusually large number of bankruptcies, failures, and forced acquisitions for corporations and financial institutions. In every recession, overextended companies and shifting business trends bring failures. However, data

[1] See A. Sinai, S. Blitz, and F. Plemenos, "The Microeconomic Effects of a Tighter Budget and Easier Monetary Policy," Data Resources Economic Studies Series No. 95, May 1982.

Chart 1
Nominal and Expected Real Aftertax Three-Month Treasury Bill Rate (Percent)

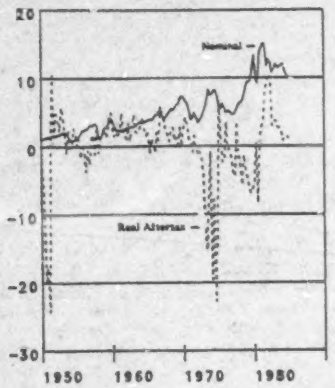
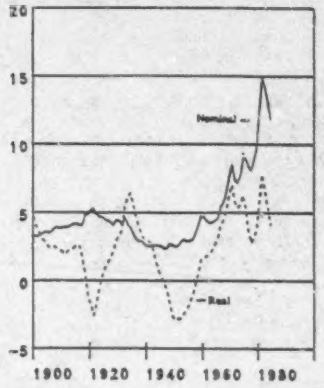


Chart 2
New Issue Rate on AAA-Equivalent Corporate Bonds: Nominal and Real Since 1900 (Percent)



on business failures compiled by Dun and Bradstreet show a total of 17,043 failures in 1981, 45% more than in 1980 and the greatest number since 1961. So far this year, 9,057 companies have failed, more than 44% ahead of last year's pace. At this rate, more failures will occur this year than at any time since 1932, when 154 of each 10,000 organizations failed.

. Thrift institutions also have been failing at an unprecedented rate. Nor have households escaped, with a record pace of bankruptcies, rising loan delinquency rates, and increasing numbers of foreclosures occurring this year. Typically, failures continue even after a recession has ended, since any pickup in business activity is spread unevenly. Thus, it seems certain that the early 1980s will be characterized by the worst shakeout of industries and firms since the Great Depression.

. Asset deflation and some debt deflation, a phenomenon not present since the 1930s. Land and real estate—including homes, natural resources such as oil, lumber, copper, lead and zinc, precious metals—and farm commodity and stock prices have been declining. This deflation is squeezing profits in many industries, eroding the value of collateral used to back loans, reducing the net worth of households, and depressing the equity of business. A deflation of asset prices, the illiquidity resulting from depressed markets for physical assets, and the necessity of distress sales occur to some extent in every downturn. But in the current episode, the three-year string of recessions and unprecedented high interest rates have so depressed cash flows that the process has been more pronounced.

. A larger and quicker drop of inflation than usual. In early 1981, inflation rates generally were in double digits. Recently, inflation rates have ranged from -3.3% to 3.6%, at annual rates. The more typical pattern is for the biggest declines of inflation to occur in the first two years after the end of a recession. In the current situation, inflation rates dropped sharply before the end of the recession, pressuring corporate profit margins.

. Depressed profits and cash flow. In 1979, corporate profits after taxes were $167.8 billion; the DRI estimate for 1982 is $117.0 billion. The estimated drop of 30.3% over the last three years is unprecedented for the postwar period and has occurred despite the tax savings from the Accelerated Capital Cost Recovery System (ACRS) enacted in 1981. As a

result, the cash flow of nonfinancial corporations was down to $226.6 billion in 1982:1, back near the level in 1981:1.

The severity of the current downturn cannot be viewed in isolation from the recessions of 1980 and 1981. In terms of depth, breadth, and duration, the experience since 1979 is unprecedented for the postwar U.S. economy. Charts 3 to 7 show that the succession of recessions has pushed the economy to a lower plateau than in early 1979. In essence, the economy has not progressed at all since that time; indeed, it is recessed currently relative to three years ago.

Stagnation, recession, and even depression characterize much of the U.S. economy at present. Table 1 shows that growth in real GNP since early 1979 is essentially zero. Business fixed investment, in real terms, has risen only 0.2% per quarter, at an annual rate. Industrial production has dropped an average 2.5% a quarter. The joblessness problem is the worst since the Great Depression, with 10.3 million unemployed, 1.3 million discouraged workers, and 2.3 part-time workers who usually work full-time—a total of over 13.[illegible] million Americans working less than desired. The unemployment rate would be even higher if labor force growth in the past year had matched the postwar average of 1.8% per annum. From April 1981 to April 1982 growth in the labor force was only 0.8%, helping to hold down the already record-high unemployment rate.

Table 1
U.S. Economic Performance Since Early 1979
(Percent change, compound annual growth rates)

Real GNP	0.1
Implicit GNP Deflator	8.5
Retail Sales (1972 dollars)	-1.3
Industrial Production	-2.5
Business Fixed Investment (1972 dollars)	0.2
Employment (Household Survey)	0.5

Unemployment rates are at record postwar peaks for all civilian workers (9.4%), craft and kindred workers (9.6%), farm workers (5.8%), service workers (11.1%), blue-collar workers (13.7%), and clerical workers (7.2%). The highest rates of unemployment are in construction (19.4%), agriculture (14.6%), durables manufacturing (11.2%), nondurables manufacturing (10.5%), and wholesale retail trade (10.1%). All but the unemployment rate for nondurables manufacturing are at postwar highs. Capacity utilization for all-manufacturing is near the all-time low of 69.0% that occurred in March 1975. Primary and advanced processing industries are operating at or near their lowest operating rates for the postwar period. The durable goods, basic metal, energy, chemical, and textile materials sectors all are operating at the lowest utilization rates since 1967. And the gap between potential and real GNP is 11.2% of total real output, the highest figure since 1950.

What has happened to business balance sheets and corporate liquidity during this period as a result? Since 1977, business balance sheets and corporate liquidity have been steadily deteriorating. In all cases, the various summary measures for balance sheet strength and the liquidity of nonfinancial corporations are at record weak positions, suggesting that corporate financial health is in the worst state of the postwar period.

DRI estimates show the debt service burden proxy at 46.7% in 1982:1, a new postwar high. The previous peak was 44.9% in 1974:3, just prior to a turn toward deep recession by the business sector. The ratio of short-term to total debt outstanding is 42.5%, also a record high. In the credit crunch of 1974, the peak was 38.0%. Leverage, defined as total debt outstanding relative to the net worth of nonfinancial corporations, is at a new peak.[2] The quick ratio of nonfinancial corporations is 37.7%, a postwar low. Cash flow, in real terms, is now below the levels of 1977. And with a three-year squeeze on profits since 1979, equity in nonfinancial corporations has been rising only slowly.

One consequence has been an extraordinarily heavy pace of business borrowing from banks, with commercial and industrial loans at large weekly reporting banks, on a seasonally

[2]Net worth of nonfinancial corporations is calculated by DRI as the sum of financial and physical assets less total liabilities, both short- and long-term. The series for physical assets is calculated by DRI.

Chart 3
Retail Sales of New Cars - Total Since 1977
(Millions of units, annual rates, SA)

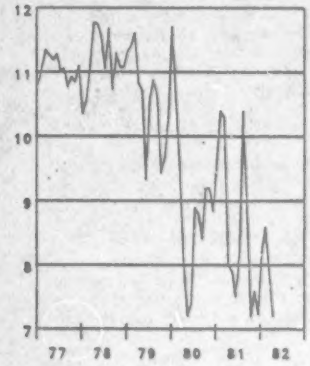


Chart 4
Retail Sales Since 1977
(Billions of 1972 dollars, annual rates, SA)

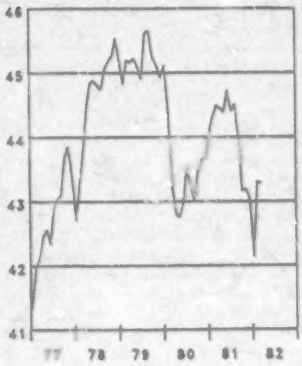


Chart 5
Federal Reserve Industrial Production Since 1977
Index - Total (SA, 1967 = 1.0)

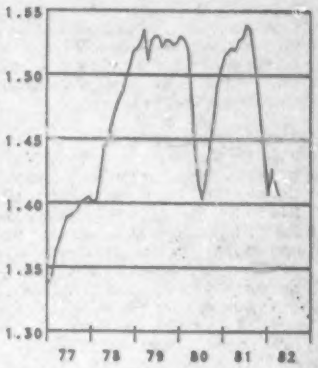


Chart 6
Capacity Utilization in Manufacturing Since 1977
Total (Percent, SA)

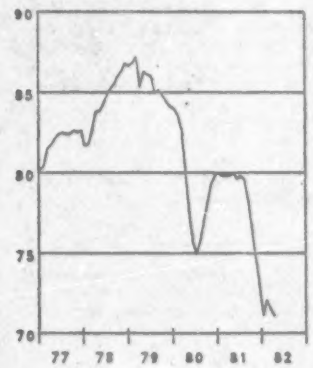
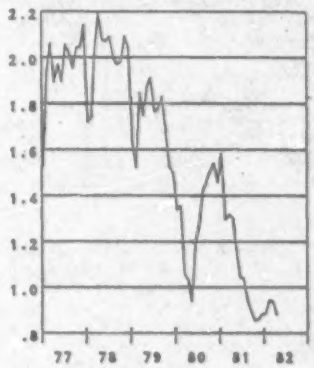


Chart 7
Housing Starts Since 1977
(Millions of units, annual rates, SA)



adjusted basis, up a huge 17.6% over the past year and 18.4% for the past month. Issues of nonfinancial commercial paper also are sharply higher, up 40.1% during the past year. With prolonged weakness in the bond and stock markets, these sources of funds essentially have been closed to much of the business sector, forcing corporations to borrow heavily at commercial banks on a short-term basis. Small businesses are finding that bank funds are unavailable or prohibitively costly. This particular pattern of available sources for external finance has worsened the problem of business liquidity, since short-term debt is costly and must be rolled over more frequently. In addition, the usual funding for repayments of short-term debt by long-term issues and corresponding lengthening of debt maturities have not occurred.

Nonfinancial corporations are not the only institutions whose financial position has weakened. The increasing preponderance of short-term bank debt in the liability structure of business has increased the risk to banks of loan losses and, in turn, is contributing to a deterioration of bank balance sheets. Financial institutions including banks, thrifts, insurance companies, and consumer finance companies also are being damaged in the current environment. For banks, nonperforming loans and loan loss threats are substantial, along with some problem loans from abroad. Delinquency rates are rising at most financial institutions, despite very cautious credit policies at most commercial banks and thrifts.

Why is the financial well being of business the worst in modern history? The current situation

Table 2
Measures of Balance Sheet Strength and Liquidity: Nonfinancial Corporations, 1955 to 1981

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
Cash Flow/Capital Outlays (*1)...	99.99	86.34	94.73	118.80	103.08	98.06	101.24	93.68	96.27	93.49	97.90	91.72	80.69
Financial Assets/Short-Term Liabilities (*2)	182.96	141.44	132.66	139.80	138.34	113.65	114.73	113.41	111.65	100.62	87.79	75.19	80.62
Debt Burden Proxy/Cash Flow (*3).	7.72	8.49	9.93	10.76	11.36	12.77	14.13	13.35	13.74	13.90	13.50	14.07	16.00
Debt/Equity (*4).....	52.88	55.63	57.44	58.93	60.38	62.53	64.45	65.95	67.58	68.80	71.42	74.62	77.47
Short-Term/Total Liabilities (*5)	28.01	30.08	29.23	27.34	28.30	29.33	28.73	28.63	28.82	29.91	32.11	32.80	32.63

	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Cash Flow/Capital Outlays (*1)...	78.71	69.30	71.06	81.51	79.78	68.31	61.36	112.84	97.80	91.13	88.54	87.57	94.38	91.05
Financial Assets/Short-Term Liabilities (*2)	66.05	57.02	53.74	58.61	57.80	52.73	45.64	55.39	57.15	50.82	46.11	42.94	41.45	38.28
Debt Burden Proxy/Cash Flow (*3).	19.60	25.48	31.73	28.68	28.12	31.05	38.79	29.78	34.36	35.04	36.58	39.37	38.17	41.20
Debt/Equity (*4).....	82.68	88.27	94.58	98.01	102.42	112.22	120.07	128.07	122.44	134.85	129.14	133.78	137.34	140.82
Short-Term/Total Liabilities (*5)	33.30	35.15	34.23	32.46	32.89	35.64	36.23	35.05	34.89	35.74	37.37	39.75	39.99	41.95

(*1) Cash flow equals the sum of retained earnings, foreign branch profits, capital consumption allowances, and the inventory valuation adjustment. Capital outlays equal the sum of plant and equipment expenditures, inventory accumulation, and residential construction.
(*2) Financial assets equal the sum of money, deposits, U.S. Government bonds, State and local bonds, and commercial paper. Short-term liabilities equal the sum of bank loans, open-market paper, finance company loans, and U.S. Government loans.
(*3) Debt burden proxy equals the sum of the weighted average of past new issue rates multiplied by the beginning-of-period level of bonds, the weighted average of past prime rates multiplied by the beginning-of-period level of bank loans, and the weighted average of past 4-6 month commercial paper rates multiplied by the beginning-of-period level of open market paper.
(*4) Debt equals the sum of bank loans, mortgages, bonds, open-market paper, finance company loans, and miscellaneous liabilities. Equity equals the difference between total assets and total liabilities. Total assets equal the sum of financial assets, physical assets (not stocks), and other miscellaneous assets. Total liabilities equal short-term liabilities, long-term liabilities, and other miscellaneous liabilities.
(*5) Total liabilities equal the sum of short-term liabilities, bonds, plus mortgages.

can be traced to the particular policy mix that has been used to break the severe, accelerating inflation of 1965 to 1980. The severe inflation itself encouraged and induced aggressive expansion by business, heavy borrowing, and sales of financial assets to fund activities. Like many other sectors, business funded expansionary activities through inflation-generated revenue flows. Eventually, as in other business cycle episodes, too rapid expansion sowed the seeds of a later downturn.

In order to deal with the situation and to stop a sharp depreciation of the U.S. dollar, the Federal Reserve radically altered its policy approach on October 6, 1979. Tough measures on reserves and the discount rate were taken, but most important, the central bank switched from targeting short-term interest rates as the means for achieving its monetary growth goals to controlling bank reserves.

The tightening of monetary policy was followed by a move toward budget tightness by the Carter Administration in March 1980. At the same time, credit controls were instituted by the Federal Reserve for the first time during peacetime. The squeeze of high nominal and real interest rates, credit controls, and fiscal restraint pushed the economy into the sharpest recession of the postwar period. Huge declines of interest rates--from 153 to 834 basis points between April and June 1980--helped to reverse the downturn and stimulate a vigorous new expansion from July 1980 to January 1981. But except for a brief three-month period of ease

Table 3
Measures of Balance Sheet Strength and Liquidity: Nonfinancial Corporations, 1976:3 to 1982:1

	1976		1977				1978				1979			
	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Cash Flow/Capital Outlays (*1)...	95.8	99.1	90.5	93.2	95.8	97.1	88.2	87.0	90.1	88.8	88.3	85.5	88.0	88.5
Financial Assets/Short-Term..... Liabilities (*2)	58.0	57.2	55.6	51.8	51.5	50.8	48.9	47.7	46.7	46.1	44.1	42.7	42.2	42.5
Debt Burden Proxy/Cash Flow (*3).	27.5	26.7	25.0	25.0	24.5	25.6	26.9	25.1	26.1	26.6	26.6	27.9	29.1	33.9
Debt/Equity (*4).....	122.0	122.9	123.5	123.8	124.6	126.7	128.6	129.0	129.2	129.8	130.9	132.7	134.3	136.2
Short-Term/Total Liabilities (*5)	34.4	34.7	34.8	35.3	35.5	35.7	36.4	36.7	36.9	37.4	38.1	38.9	39.5	39.7

	1980				1981				1982
	I	II	III	IV	I	II	III	IV	I
Cash Flow/Capital Outlays (*1)...	87.2	93.1	99.4	97.8	94.0	90.5	88.8	90.9	103.3
Financial Assets/Short-Term..... Liabilities (*2)	42.4	42.5	43.2	41.4	41.9	40.9	38.5	38.3	37.7
Debt Burden Proxy/Cash Flow (*3).	35.8	35.6	34.2	30.9	30.4	39.0	42.0	45.3	46.7
Debt/Equity (*4).....	137.0	136.9	136.7	137.9	136.5	139.7	142.9	144.2	145.5
Short-Term/Total Liabilities (*5)	40.1	39.6	39.6	40.0	39.7	40.4	41.7	42.0	42.5

(*1) Cash flow equals the sum of retained earnings, foreign branch profits, capital consumption allowances, and the inventory valuation adjustment. Capital outlays equal the sum of plant and equipment expenditures, inventory accumulation, and residential construction.
(*2) Financial assets equal the sum of money, deposits, U.S. Government bonds, State and local bonds, and commercial paper. Short-term liabilities equal the sum of bank loans, open-market paper, finance company loans, and U.S. Government loans.
(*3) Debt burden proxy equals the sum of the weighted average of past new issue rates multiplied by the beginning-of-period level of bonds, the weighted average of past prime rates multiplied by the beginning-of-period level of bank loans, and the weighted average of past 4-6 month commercial paper rates multiplied by the beginning-of-period level of open market paper.
(*4) Debt equals the sum of bank loans, mortgages, bonds, open-market paper, finance company loans, and miscellaneous liabilities. Equity equals the difference between total assets and total liabilities. Total assets equal the sum of financial assets, physical assets (not stocks), and other miscellaneous assets. Total liabilities equal short-term liabilities, long-term liabilities, and other miscellaneous liabilities.
(*5) Total liabilities equal the sum of short-term liabilities, bonds, plus mortgages.

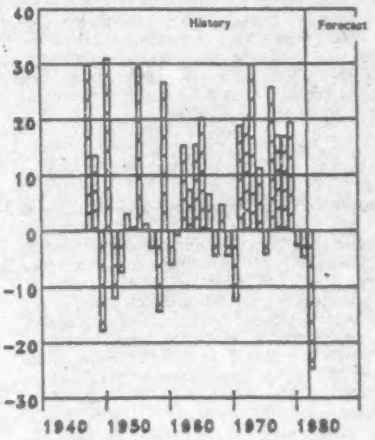
during the recession that spring, monetary policy has held to an unprecedented posture of restraint.

After the 1980 election, the Reaganomics fiscal program was announced and explicitly presented in the budget for fiscal year 1982. The bottom line of the Reagan budget was essentially no fiscal stimulus for 1981 and 1982, but increasingly large injections of stimulus into the economy from 1983 to 1986.[3] From the prospects of such heavy fiscal stimulus, four years of record federal budget deficits, the likely huge Treasury financing that would be required, and most importantly, a nonaccommodative monetary policy, financial market participants expected much higher interest rates. These views were quickly discounted into market prices, especially raising long-term bond yields to unprecedented levels relative to inflation and for a recession. The impact of the Reaganomics budget thus acted to restrain real economic growth during 1981 and 1982.

The 1980 recession was concentrated on interest-sensitive industries, a rather narrow segment of the economy. However, by mid-1981, the impacts of continuing high nominal and real interest rates had spread to other sectors as well. By year-end, a full-blown and widespread recession was in process in the U.S. economy, with few sectors or areas escaping the impact.

The sequence of recessions since 1979 depressed profits and cash flow, resulting in a greater pace of corporate external financing to fund the still strong expansionary activities of the business sector. The weakened growth in profits slowed the growth in retained earnings and equity, contributing to increased leverage. A preference for debt financing because of the tax system also raised leverage. With the greater leverage, fluctuations in sales brought an increased risk to bottom-line earnings. Most indebtedness taken on was short-term, reflecting weak long-term bond markets. The resulting business demands for short-term credit propped interest rates, especially in an environment of nonaccommodative Federal Reserve policy. The weak cash flow provided less coverage for the rapidly growing interest burden on outstanding debt, worsening further the liquidity of business, and reducing profits through greater interest expenses. Thus, the depressed level of profits is a major reason for the current financial squeeze on nonfinancial corporations.

Chart 8
Corporate Profits Perfomance in the Postwar Period(Percent change)*



*Includes 1982 forecast

Further, unprecedented high and volatile nominal and real interest rates under the New Fed Policy increased the returns on bonds required by investors and essentially eliminated the bond market as a viable source of funds for corporations. With large risks of capital losses in the new environment and a severe inflation still in place, business had no other choice but to sustain external financing, primarily through bank borrowing and issues of nonfinancial corporate paper. The resulting sharp rise in the ratio of short- to long-term debt greatly increased the financial fragility of the business sector, requiring frequent refinancing to repay debt service and outstanding loans.

Finally, and perhaps most critical, record high nominal and real aftertax interest rates have

[3]For a discussion of the effects from the proposed Reagan tax and spending policies, see Alien Sinai, "New Approaches to Stabilization Policy and the Effects on U.S. Financial Markets," National Tax Journal, September 1981, pp. 341-369.

been in place, the result of a restrictive monetary policy strong demands for short-term credit, large Treasury deficits and issues of debt, and the prospects for a loose fiscal-tight monetary policy mix. The high interest rates have increased interest charges on outstanding debt which, in the face of weakened cash flow, has become quite onerous. The tight monetary policy and high interest rates have also extended and deepened the recession, worsening the flow of corporate profits.

BUSINESS LIQUIDITY: MICRO DETAILS

Charts 9 to 13 depict the unfolding patterns of deterioration in the financial position of nonfinancial corporations. In the early quarters of this process, rapidly rising prices decreased the real value of cash flow, increased the replacement cost of new capital outlays, and raised profits tax liabilities because of capital gains on inventories. At the same time that cash flow was weakening, inflation rates raised the nominal requirements for external financing associated with a given pace of real capital outlays. Indeed, high rates of inflation tended to induce spending on plant and equipment by increasing the expected return on investment and reducing the real aftertax cost of borrowing. The distortions from double-digit inflation and the corporate tax system helped bring a period of intensified capital outlays, not otherwise justified. As Chart 9 shows, the ratio of cash flow to capital outlays was well below 100% from 1976 to 1981, indicating a large "financing gap" for nonfinancial corporations.

In order to meet their financing needs, corporations reduced the accumulation of financial assets and borrowed heavily. The reduction in the ratio of financial assets to short-term liabilities is one indication of this trend; there has been a decline from a cyclical peak of 56% in early 1973 to a low of 37.7% in 1982:1. At the same time, the increased volatility of long-term bond rates vis-a-vis other markets and congestion from heavy Treasury deficit financing in 1980 and 1981 made long-term bond financing extremely difficult. The large increase in the ratio of short-term to total debt for nonfinancial corporations reflects this phenomenon.

The strong need for external financing and diminished cash flow contributed to a rising debt service burden. Unprecedented high levels of nominal and real interest rates brought about by increased volatility in the financial markets, a tight Federal Reserve policy, heavy deficit financing, and the deregulation of the financial services industry pressed many firms. Unfortunately, the recession in 1980 was very brief, providing only little relief on inflation and no sustained rise in cash flow to help ease the debt service burden. In addition, the automatic rises of interest rates under the New Fed Policy meant that debt service burdens were restored quickly to extremely high levels. Distress borrowing and the continued pressure on a large number of industries in the U.S. economy tended to keep short-term indebtedness high, as did the inability to finance much with bonds or stocks in a weak equity market. In recent quarters the volume of bond and stock issues has been far below what usually occurs in recession and in the early stages of recovery.

Finally, the leverage of nonfinancial corporations has been steadily rising since the trough of the 1974–75 recession, reaching a new high in 1982:1. The increased leverage is a result of the squeeze on earnings and rising level of indebtedness necessary to continue operations. The increased leverage magnifies the impacts of swings in earnings, with the effects of depressed sales flowing more to the bottom line in highly leveraged situations than when leverage is low. The high leverage indicates too high a level of outstanding indebtedness, too little profits growth, and too great a vulnerability to continued recession for much of the corporate sector.

Table 4 shows the profit performance since 1956 of 15 sectors monitored by the DRI Industry Financial Service. Clearly, profits growth has been weaker in the latest series of business cycle downturns, on average, than in most of the postwar period. Fourteen of fifteen sectors show a worse profits performance from 1979 to 1982 than over the historical period 1956 to 1978. Auto-related, construction-related, financial, metals and mining, oil-related, primary processing manufacturing, retail stores, technology-related, and transportation sectors all are estimated to show lower profits in 1982 than 1979.

Some 63 industries out of a total of 81 monitored by the DRI Industry Financial Service show profits growth over recent years

Chart 9
Ratio of Cash Flow to Capital Outlays for Nonfinancial Corporations: 1955 to 1982:1

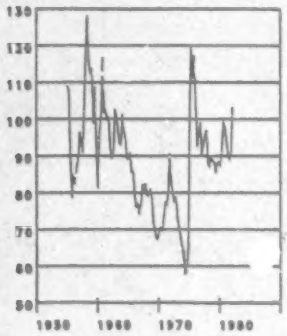
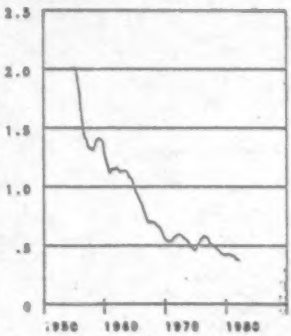
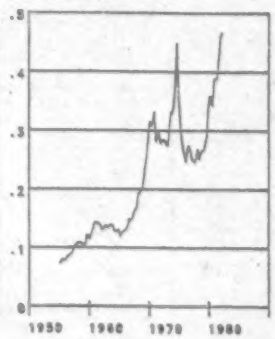


Chart 10
*"Quick" Ratio for Nonfinancial Corporations: 1955 to 1982:1**



*The "quick" ratio is total financial assets to short-term liabilities.

Chart 11
*Debt Service Burden of Nonfinancial Corporations: 1955 to 1982:1**



*The debt service burden is a weighted average of the cost of outstanding bond and mortgage indebtedness, bank loans, and commercial paper as a ratio of gross internal funds.

Chart 12
Ratio of Short to Total Debt of Nonfinancial Corporations: 1955 to 1982:1

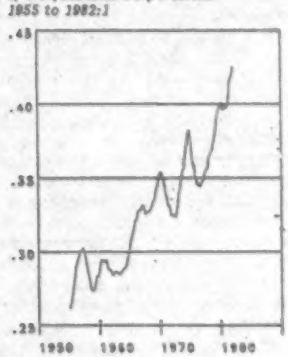
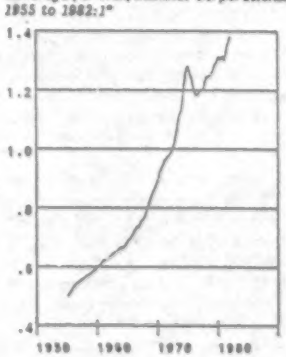


Chart 13
*Leverage for Nonfinancial Corporations: 1955 to 1982:1**



*Leverage is the ratio of total debt, both short-and long-term, to equity, defined as total assets, physical and financial, less total liabilities.

Total debt / EQUITY

Table 4
Profit Performance by Sector
(Percent growth)

	1956-1978	1979-1982F
Auto-Related	6.9	-33.7
Consumer-Household-Related	11.3	4.3
Construction-Related	10.3	-23.6
Financial	22.1	-0.7
Food and Beverages	11.0	8.2
Specialty Machinery	11.0	0.5
Metals and Mining	4.6	-27.1
Miscellaneous Manufacturing	11.1	0.6
Miscellaneous Services	14.5	3.6
Oil Related	7.6	-5.2
Primary Processing Manufacturing	5.2	-5.7
Retail Stores	9.6	-4.2
Technology-Related	12.7	-1.1
Transportation	13.0	NM
Utilities and Communications	9.1	10.0
Total of all Sectors	10.4	-2.4

*Growth calculated from 1962 to 1978.
Growth between first year and last year at compound annual rates.
NM-1982 Forecast values for profits are negative.
F-Forecast, DRI Industry Financial Service.

of a considerably lesser magnitude than before. To some extent, the weakness of corporate profits is a result of the more rapid expensing of capital outlays permitted through the ACRS. But even without this negative offset to profits, the performance would be extremely weak. Since 1979, 46 industries are estimated to have shown a negative growth in profits, and six industries now show only slight positive growth.

The impacts of the weakened profits on leverage by sector and industry have been substantial. The average leverage for 13 broad sectors over the period 1974 to 1980 was 56.8%. Two of the sectors had average leverage ratios over 100%. Nine sectors show a leverage less than average, although still relatively high. For 1981, the estimated leverage had risen in nine of the sectors, with the largest increases in auto-related, retail stores, metals and mining, miscellaneous services, and transportation.

By industry, ten had debt-to-equity ratios of 75% or greater, on average, from 1974 to 1980. This performance compares with the lower historical average of 56.8% for all sectors and much lower leverage, on average, for virtually all of these industries. But for 1981, DRI estimates show much greater leverage by industry, with 46 above the average values from 1974 to 1980. Sharp rises occurred in air transport, automobiles, beverages-distillers, beverages-soft drinks, building materials-cement, building materials-roofing and wallboard, chemical, containers-paper, coal-bituminous, confectionary, cosmetics, electric household appliances, bakers-biscuit, cake and bakers, foods-canned, foods-meat packing, forest products, lead and zinc, miscellaneous metals and mining, oil-integrated domestic, publishing, retail department stores, retail stores-food chains, retail stores-mail order and general chains, railroad equipment, radio-TV broadcasting, retail stores-variety, tobacco, and vending machines and food services.

Why such high leverage? First, corporate profits have been declining for three consecutive years, reducing retained earnings and contributing to a weak performance for equity. Second, short-term debt has jumped and long-term debt has only been slowly retired, if at all. Third, issues of net new shares by nonfinancial corporations have been limited; indeed, in 1981 there was a drop of $6.9 billion in the nonfinancial corporate sector as more stock was retired than sold.

[4] The DRI Industry Financial Service profits series are corrected for this effect.

What all of this means is that corporate America is more vulnerable to a continuation of the recession than ever before, with the likely result a shakeout for both large and small businesses of unprecedented proportions for the postwar period. Impacts on financial institutions are bound to occur, too, since the large volume of loans outstanding and interest charges will be difficult to repay, so that commercial banks and insurance companies are also at risk. Thrift institutions already are being shaken out, the result of three years of disi[illegible]ediation and large declines of net worth, with a huge consolidation movement in process.

BUSINESS FINANCIAL FRAGILITY: A THREAT TO RECOVERY?

The deterioration of business balance sheets and liquidity has already been the source of a substantial number of business failures. The number of business failures so far in 1982 is well on the way to a new postwar record, and may even surpass the record 31,822 failures that occured in 1932. The potential for

Table 5
Profit Performance by Industry
(Percent growth)

	1956-1978	1979-1982F
Aerospace	10.3	1.1
Agricultural Machinery	8.3	NM
Air Transport	12.3	NM
Aluminum	6.6	-28.2
Auto Accessories	8.3	-11.2
Automobiles	7.[illegible]	-88.1
Banks	[illegible].6*	5.5
Beverages-Brewers	9.1**	14.9
Beverages-Distillers	6.1	18.2
Beverages-Soft Drinks	13.7	4.0
Building Materials - Cement	6.4	-12.6
Building Materials, Heating, AC & Plumbing	9.2	-12.6
Building Materials - Roofing & Wallboard	7.7	-28.5
Chemicals	6.6	-6.2
Conglomerates	12.8	1.7
Containers-Metal and Glass	6.8	-3.2
Containers-Paper	8.9	-9.1
Coal-Bituminous	3.8	-9.6
Confectionery	5.3	3.5
Construction & Material Handling Machinery	11.0	-8.8
Copper	-1.1	-40.7
Cosmetics	11.8	2.4
Drugs	12.3	5.3
Electronic/Electrical Components & Equipment	26.2	0.1
Elect Controls, Switching & Connector Equip	10.6	-2.1
Electric Companies	8.6	11.6
Electric Household Applicances	8.9	-23.0
Electronic Laboratory Equipment	22.1	9.0
Electronic Major Companies	10.2	0.4
Semiconductor Manufacturers	21.2	-18.6
Foods-Dairy Products	12.4	4.5
Bakers-Biscuit, Cake & Bakers	8.1**	-1.3
Foods-Canned	8.5	6.5
Foods-Corn Refiners	17.5	15.8
Foods-Meat Packing	-0.4	-1.0
Foods-Packaged	9.5	5.5
Forest Products	13.2	-26.5
Gas	7.6	13.6
Home Furnishings	10.0	-10.9
Hotel & Motel	12.5	16.0
Industrial Machinery	9.9	-3.4
Lead and Zinc	2.1	-42.2
Machine Tools	11.3	-10.8
Medical Supplies & Equipment	16.9	9.4
Fabricated Metals	8.1	-4.3
Miscellaneous Metals & Mining	4.4	-16.1
Computers	15.1	-1.4
Office & Business Equipment	17.0	-6.8
Oil-Crude Producers	14.5	-10.0
Oil-Integrated, Domestic	9.0	0.9
Oil-Integrated, International	6.8	-8.3
Machinery & Services - Oil Well	15.1	24.9
Off-Shore Drilling	31.8***	52.0
Publishing	13.4	4.0
Photography	11.2	4.3
Pollution Control Equipment	20.9	-5.2
Paper	7.0	-3.9
Retail Stores-Drug Store Chains	15.8	10.2
Retail Department Stores	10.5	-0.8
Restaurants	28.6	5.7
Retail Stores-Food Chains	10.7	2.3
Real Estate & Homebuilding	36.1**	-28.7
Retail Stores-Mail Order & General Chains	8.2	-7.4
Railroad Equipment	8.0	-4.9
Radio-TV Broadcasting	13.9	-0.6
Radio - TV Manufacturers	14.8	34.2
Retail Stores - Variety	9.7	-18.9
Savings & Loans	13.7**	NM
Shoes	10.7	6.0
Small Loans	7.7	-20.1
Soaps	10.9	4.0
Diversified Machinery	8.4	6.4
Steel	1.7	-5.7
Steam Generating Machinery	13.7	3.6
Telecommunications	9.7	8.0
Tire and Rubber	4.2	-1.9
Truck Lines	18.8	-11.0
Tobacco	10.0	9.2
Textile Apparel	14.6	-2.4
Textile Products	8.4	-4.5
Vending Machines & Food Services	19.1	-11.0

Growth between the first year and last year at compound rates.
NM-1982 forecast values for profits are negative.
*Growth calculated from 1950 to 1978.
**Growth calculated from 1964-1978.
***Growth calculated from 1957 to 1978.
F-DRI Industry Financial Service

ble 6
*Leverage by Sector and Industry**
(Percent)

Industries

	1974-1980	1980	1981**
Aerospace	41.2	34.0	38.5
Agricultural Machinery	65.4	87.9	99.2
Air Transport	116.8	106.9	180.7
Aluminum	68.0	49.2	66.1
Auto Accessories	36.1	36.3	37.2
Automobiles	29.1	40.3	54.3
Beverages-Brewers	44.3	55.2	NA
Beverages-Distillers	58.1	54.4	79.3
Beverages-Soft Drinks	21.0	28.6	38.1
Building Materials - Cement	54.9	68.0	81.5
Building Materials, Heating, AC & Plumbing	57.5	57.4	57.3
Building Materials - Roofing & Wallboard	58.0	57.9	70.1
Chemicals	53.7	51.7	64.4
Conglomerates	67.3	59.3	67.7
Containers-Metal and Glass	56.1	58.5	53.6
Containers-Paper	38.7	40.0	47.2
Coal-Bituminous	67.2	74.0	98.0
Confectionery	15.0	26.7	24.1
Construction & Material Handling Machinery	50.4	41.5	47.2
Copper	48.2	35.7	37.9
Cosmetics	32.2	36.6	46.4
Drugs	30.1	29.5	33.0
Electronic/Electrical Components & Equipment	42.7	37.7	36.6
Elect Controls, Switching & Connector Equip	29.3	27.6	25.8
Electric Companies	153.9	147.8	146.4
Electric Household Applicances	50.7	57.6	61.4
Electronic Laboratory Equipment	14.2	20.3	17.5
Electronic Major Companies	36.2	34.7	43.7
Semiconductor Manufacturers	20.3	35.1	20.2
F[illegible]s-Dairy Products	36.5	36.3	45.7
[illegible]s-Biscuit, Cake & Bakers	46.9	47.3	70.4
[illegible]s-Canned	38.4	48.6	53.4
Foods-Corn Refiners	238.8	280.7	38.0
Foods-Meat Packing	58.3	44.8	87.5
Foods-Packaged	44.3	38.9	50.0
Forest Products	64.2	63.0	75.1
Gas	140.6	115.2	127.2
Home Furnishings	44.5	39.0	38.0
Hotel & Motel	92.5	85.5	97.6
Industrial Machinery	46.9	48.7	40.2
Lead and Zinc	57.0	58.7	106.7
Machine Tools	44.1	41.6	38.4
Medical Supplies & Equipment	18.5	18.6	22.3
Fabricated Metals	95.7	92.7	73.7
Miscellaneous Metals & Mining	64.1	73.5	90.2
Computers	20.5	25.6	26.1
Office & Business Equipment	51.1	34.1	33.8
Oil-Crude Producers	65.0	57.0	66.5
Oil-Integrated, Domestic	43.7	39.1	53.2
Oil-Integrated, International	38.8	33.8	43.7
Machinery & Services - Oil Well	32.2	37.6	26.7
Off-Shore Drilling	124.5	88.4	77.3
Publishing	23.9	32.1	46.1
Photography	7.9	9.3	7.6
Pollution Control Equipment	54.5	61.1	58.3
Paper	50.4	42.9	42.8
Retail Stores-Drug Store Chains	22.0	16.9	20.2
Retail Department Stores	44.4	42.6	46.0
Restaurants	100.3	100.4	102.6
Retail Stores-Food Chains	43.6	46.9	88.4
Retail Stores-Mail Order & General Chains	76.8	80.7	89.5
Railroad Equipment	74.3	68.6	103.7
Radio-TV Broadcasting	34.7	33.0	54.1
Radio - TV Manufacturers	51.5	60.8	NA
Retail Stores - Variety	31.6	29.2	82.8
Shoes	24.1	21.0	32.7
Soaps	29.2	34.6	29.7
Diversified Machinery	46.1	38.4	38.8
Steel	41.3	44.4	44.6
Steam Generating Machinery	36.8	24.5	22.3
Telecommunications	106.3	102.8	97.7
Tire and Rubber	65.7	57.1	58.8
Truck Lines	54.4	50.8	38.0
Tobacco	67.2	67.6	80.7
Textile Apparel	41.7	40.3	40.8
Textile Products	45.5	42.8	43.2
Vending Machines & Food Services	52.8	58.4	66.9

Sectors

	1974-1980	1980	1981
Auto Related	33.1	42.3	52.8
Consumer Household Related	35.1	35.7	NA
Food and Beverages	41.4	41.6	NA
Retail Stores	52.2	54.7	75.8
Metals and Mining	62.5	54.6	70.4
Miscellaneous Manufacturing	65.8	59.4	67.7
Oil Related	42.3	37.4	48.5
Primary Processing Manufacturing	49.4	48.2	55.2
Specialty Machinery	45.9	43.3	43.7
Technology Related	31.2	30.4	32.4
Miscellaneous Services	48.1	50.0	67.6
Transportation	106.6	96.8	148.6
Utilities and Communications	125.0	119.4	118.9
Total - All	56.8	54.1	NA

*Source: DRI Industry Financial Service
**Source for 1981 data: DRI Loan Growth Credit Risk Service

business failures is related to downward pressure on earnings, high leverage, and a large amount of debt to be repaid or refinanced. Little help will be forthcoming from the federal government, with its biased approach toward deregulation and competition.

Undoubtedly, there will be a further fallout of failures for corporations and financial institutions in this episode. The potential casualty list of sectors, industries, firms, and states is being monitored by the DRI Industry Financial Service. Several sectors, 13 industries, and nearly 100 firms are at risk, including some familiar names such as Chrysler, International Harvester, and Massey Ferguson. Certainly, some will not survive the current episode. And, there is a significant risk that a large number of bankruptcies could sustain the recession longer or prevent a sustainable

Table 7
Business Failures Since 1925

Year	Number of Failures	Failure Rate Per 10,000 Listed Concerns
1925	21,214	100
1926	21,773	101
1927	23,146	105
1928	23,842	109
1929	22,909	104
1930	26,355	122
1931	28,285	133
1932	31,822	164
1933	19,859	100
1934	12,091	61
1935	12,244	62
1936	9,607	48
1937	9,490	46
1938	12,836	61
1939	14,768	70
1940	13,619	63
1941	11,848	55
1942	9,405	45
1943	3,221	16
1944	1,222	7
1945	809	4
1946	1,129	5
1947	3,474	14
1948	5,250	20
1949	9,246	34
1950	9,162	34
1951	8,058	31
1952	7,611	29
1953	8,862	33
1954	11,086	42
1955	10,969	42
1956	12,686	48
1957	13,739	52
1958	14,964	56
1959	14,053	52
1960	15,445	57
1961	17,075	64
1962	15,782	61
1963	14,374	56
1964	13,501	53
1965	13,514	53
1966	13,061	52
1967	12,364	49
1968	9,636	39
1969	9,154	37
1970	10,748	44
1971	10,326	42
1972	9,566	38
1973	9,345	36
1974	9,915	38
1975	11,432	43
1976	9,628	35
1977	7,919	29
1978	6,619	24
1979	7,564	28
1980	11,742	42
1981*	17,043	62
1982**	9,057	80

*Preliminary
**To Date

Source: Dun & Bradstreet

recovery. Business capital formation is under siege as a result.

Thus, the financial fragility of the business sector constitutes a major threat to a meaningful, sustainable economic recovery. Unfortunately, only a gradual and slow reliquefication of the U.S. business sector is forecast to occur. The reasons are several. First, the loose fiscal and a relatively tight monetary policy will prop short-term interest rates and bond yields. Volatility in the financial markets also will continue, adding risk premia to nominal returns. The high interest rates will keep debt service charges from dropping, sustaining high debt burdens. Second, the recovery in corporate profits will likely be only moderate, with interest rate sensitive and derivative areas of the economy rebounding only slowly. Although leverage will decline in 1983 and 1984 from current lofty levels, relatively high debt-equity ratios will continue to plague American business. The biggest gain in retained earnings will arise from the tax savings on capital gains for inventories under the disinflation in place in the U.S. economy. Third, the necessary restructuring of debt to long-term will remain elusive, without significant declines in bond yields and reduction in the volatility and risk of holding long-term bonds. Short- to long-term debt ratios will fall only slowly.

More than any other factor, the prospects for sustained high interest rates make the likelihood of a full reliquefication very low. High nominal and real interest rates both depress economic activity and sustain high interest expense, tending to worsen most balance sheet ratios. A flat to inverted curve tends to deter long-term debt financing and the paying down of short-term indebtedness. High interest rates reduce the present value of future earnings, tend to depress stock prices, and reduce the incentives to issue new equity. Finally, high interest rates, as an expense, tend to claim a growing portion of cash flow.

The effects on businesses of weak liquidity are to limit and deter business spending on inventories, plant and equipment, and employment. The risk of bankruptcies, lower

Table 8
Potential Casualty List of Industries, Sectors, and States

Industries	Sectors
Agriculture	Small Business
Agriculture Machinery	Mortgage Finance - Thrifts
Air Transport	State and Local Government
Aluminum	
Autos	
Building Materials	
Chemicals	
Copper	
Forest Products	
Lead and Zinc	
Miscellaneous Metals and Mining	
Real Estate and Homebuilding	
Retailers	
Steel	
Trucking	

States (With latest unemployment rate, percent)

	Unemployment Rate		Unemployment Rate
Midwest		Northeast	
Michigan	15.5	Rhode Island	10.3
Indiana	12.9		
Ohio	12.0	Mid-Atlantic	
Iowa	10.2	Pennsylvania	10.3
Illinois	10.1		
Wisconsin	10.3		
West		South	
Oregon	12.0	Alabama	14.0
Washington	12.8	West Virginia	11.3
Idaho	10.8	Tennessee	12.0
Montana	10.4	Kentucky	10.7
Alaska	11.3	Arkansas	10.7
		South Carolina	10.9

credit ratings, and the inability to obtain financing make imperative a conservative posture on expansion. Should expansion in the economy arise from other sectors, the response of business must be cautious when the financial underpinnings are weak. Thus, without a major improvement in business liquidity and much greater reliquefication, the business sector cannot contribute to to an expansion of the U.S. economy for quite some time.

POLICY CHOICES AND CONCLUDING COMMENTS

The current thrust of macroeconomic policy can only aggravate the present situation, since a loose fiscal-tight money mix will sustain high interest rates. In the current environment, one choice for the Reagan Administration and Congress is to tighten fiscal policy, especially for fiscal years 1983 and 1984. Unless inflation rates drop more sharply than is currently expected, the combination of a recovering economy later this year, a tax cut stimulus, and increased military spending will require high levels of nominal and real interest rates for the Federal Reserve to achieve its money growth targets. While the DRI forecast is sanguine that a resurgence to new peaks for interest rates and another recession will not occur in 1983, the potential damage from the repeated clashes between monetary policy, fiscal policy, and the economy could be more than corporate America can withstand.

A loose fiscal-tight money mix has implications which are now generally recognized.[5] The fiscal stimulus suggests increased real economic growth, lower unemployment, more borrowing to finance an increased rate of expenditures, and the potential for an accelerated rate of inflation. These effects appear as an enlarged nominal GNP leads to increased transactions requirements for money; which, when juxtaposed against a Federal Reserve policy designed to reduce the growth of the money supply, cause higher interest rates. The higher interest rates restrict the activities of interest rate sensitive areas, offsetting to some degree the stimulus of the fiscal measures. But additional effects of high interest rates on the financial positions of business increase fragility and the potential for failures.

[5]See A. Sinai, op. cit.

What might be the impacts if policy were twisted toward a tighter fiscal-easier money stance?[6] In theory, a budget tightening alone would weaken economic activity, draining a considerable amount of purchasing power from the economy through multiplier effects. Fiscal restraint, whether from reduced spending or increased taxes, would reduce aggregate demand, output, and employment, also easing the demands for credit, both short- and long-term, emanating from the federal government and private sectors. The rate of inflation would fall and interest rates be driven lower. With lags, the increased real purchasing power of the private sector and reduced costs of financing would, to some extent, reverse the declines engendered by the fiscal restraint. However, without some offsetting easing of monetary policy, the new equilibrium level of economic activity would be considerably lower.

In this situation, no business upturn could begin unless monetary policy shifted to an easier position. If the Federal Reserve injected reserves to raise monetary growth back toward previous levels, then interest rates would be depressed further. This action would provide considerable stimulus for a rise in economic activity that could offset the effects of fiscal restraint, especially in the interest rate sensitive sectors.

On balance, it is not clear if this twist of policy would result in an improvement for the overall economy. But it is very clear that the composition of impacts would shift, with business activity on the upside for interest rate sensitive sectors, industries, and firms. Business liquidity would benefit and balance sheet ratios be improved.

The current budget impasse remains the major impediment to lower interest rates and a recovery in the economy. Both a tightening of the budget and compensatory loosening of monetary policy are necessary to relieve the current gridlock on interest rates, to enhance business cash flow, and to promote the reliquefication of business that is necessary for a durable economic recovery.

[6]A. Sinai and S. Blitz, "Clash or Compromise: The Deficits, Fed Policy, and the Economy," Data Resources Economic Studies No. 91, February 1982.

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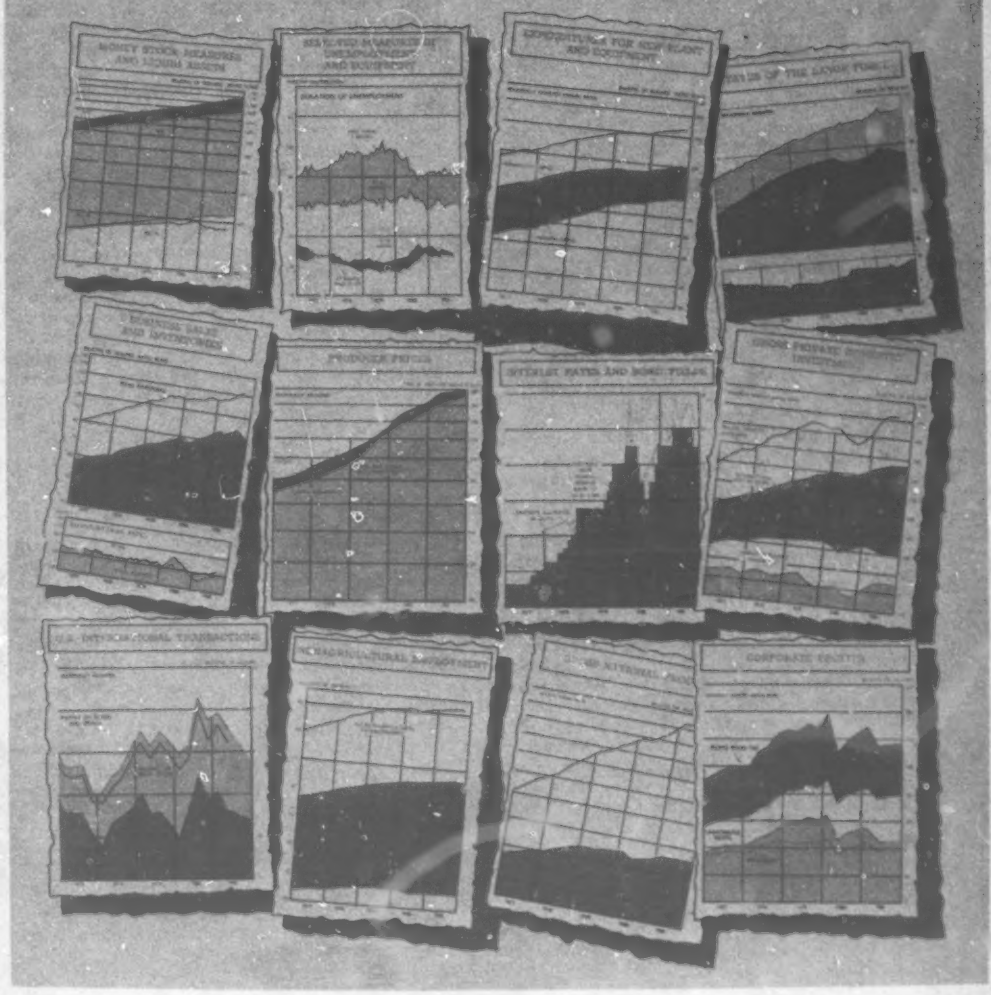
BUSINESS FAILURE RECORD



Failure Trends Since 1925

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Year	Number of Failures	Total Failure Liabilities	Failure Rate Per 10,000 Listed Concerns	Average Liability Per Failure
1925	21,214	443,744,000	100	20,918
1926	21,773	409,233,000	101	18,795
1927	23,146	520,105,000	106	22,471
1928	23,842	489,559,000	109	20,534
1929	22,909	483,252,000	104	21,094
1930	26,355	668,282,000	122	25,357
1931	28,285	736,310,000	133	26,032
1932	31,822	926,313,000	154	29,172
1933	19,859	457,520,000	100	23,036
1934	12,091	333,959,000	61	27,621
1935	12,244	310,580,000	62	25,366
1936	9,607	203,173,000	48	21,148
1937	9,490	183,253,000	46	19,310
1938	12,836	246,505,000	61	19,204
1939	14,768	182,520,000	70	12,359
1940	13,619	166,684,000	63	12,239
1941	11,848	136,104,000	55	11,486
1942	9,405	100,763,000	45	10,713
1943	3,221	45,339,000	16	14,076
1944	1,222	31,660,000	7	25,908
1945	809	30,225,000	4	37,361
1946	1,129	67,349,000	5	59,654
1947	3,474	204,612,000	14	58,896
1948	5,250	234,620,000	20	44,690
1949	9,246	308,109,000	34	33,323
1950	9,162	248,283,000	34	27,099
1951	8,058	259,547,000	31	32,210
1952	7,611	283,314,000	29	37,224
1953	8,862	394,153,000	33	44,477
1954	11,086	462,628,000	42	41,731
1955	10,969	449,380,000	42	40,968
1956	12,686	562,697,000	48	44,356
1957	13,739	615,293,000	52	44,784
1958	14,964	726,258,000	56	48,667
1959	14,053	692,808,000	52	49,300
1960	15,445	938,630,000	57	60,772
1961	17,075	1,090,123,000	64	63,843
1962	15,782	1,213,601,000	61	76,898
1963	14,374	1,352,593,000	56	94,100
1964	13,501	1,329,223,000	53	98,454
1965	13,514	1,321,666,000	53	97,800
1966	13,061	1,385,659,000	52	106,091
1967	12,364	1,265,227,000	49	102,332
1968	9,636	940,996,000	39	97,654
1969	9,154	1,142,113,000	37	124,767
1970	10,748	1,887,754,000	44	175,638
1971	10,326	1,916,929,000	42	185,641
1972	9,566	2,000,244,000	38	209,099
1973	9,345	2,298,606,000	36	245,972
1974	9,915	3,053,137,000	38	307,931
1975	11,432	4,380,170,000	43	383,150
1976	9,628	3,011,271,000	35	312,762
1977	7,919	3,095,317,000	28	390,872
1978	6,619	2,656,006,000	24	401,270
1979	7,564	2,667,362,000	28	352,639
1980	11,742	4,635,080,000	42	394,744

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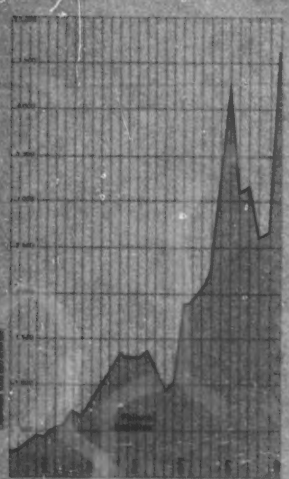
About 1980

Failures Climb Sharply: Rising at an accelerating rate, commercial and industrial failures climbed 55 percent in 1980 to 11,742, the most in 13 years. This extended the moderate 14 percent upturn in 1979 and edged business casualties above the 11,432 which occurred during the 1975 recession. While the upsurge in failing businesses prevailed throughout 1980, the rate of increase compared with 1979 steepened sharply in the last two quarters of the year.

As the number of concerns failing reached a 13-year high, the dollar volume of liabilities hit a new record of $4,635,080,000. In only one other year, 1975, had liabilities topped the $4 billion mark. Casualties of all sizes were more numerous than in 1979, but the sharpest jump —68 percent—took place in the $100,000 to $1 million liability class. Though not up quite as steeply, million-dollar bankruptcies hit an all-time high of 643.

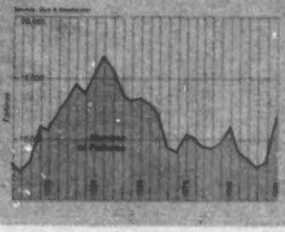
Casualties by Industry: Failures in the construction and service industries soared more than 70 percent between 1979 and 1980. Service businesses had the heaviest toll since 1875, while the construction toll was the heaviest since 1967. Builders of single-family homes showed the most severe impact. Retailing casualties climbed 54 percent overall to a 13-year peak, with some lines suffering far more severely. In the automotive category, the number of failing concerns nearly doubled. Home goods stores and building materials dealers reflected the effects of the long slump in home construction as their casualties ran half again as high as in the previous year. In contrast, failures mounted more modestly in manufacturing, up 37 percent, and wholesaling, up 41 percent. 1980 changes were minimal in two manufacturing industries—food products and chemicals—and in apparel wholesaling.



Comparative Rates: Before meaningful comparisons can be made of the severity of casualties in one line against another, adjustment must be made for the differences of size in each group. This is similar to relating highway or airline fatalities to the thousands of miles travelled. When retailing failures are expressed as a rate per 10,000 operating concerns (see page 6), children's and infants' wear shops remained highest in 1980 as they had a year earlier. Furniture stores and sporting goods dealers moved up to the second and third rankings, displacing the camera-photo supply stores and women's ready-to-wear shops, which had held those positions in 1979. The most noteworthy move toward higher casualties per 10,000 occurred among auto dealers—from nineteenth to ninth.

The Geographic Distribution: In all major geographic regions, more businesses floundered in 1980 than in the preceding year. Increases ranged from mild rates in the New England and Middle Atlantic States to extremely substantial jumps in the East South Central, South Atlantic, Mountain and Pacific States. Rising sharply were casualties in Florida, Kentucky, Mississippi, Montana, New Mexico and Washington. Most of the year-to-year climb in failures was concentrated in non-metropolitan areas, up 62 percent vs. 23 percent in the largest U.S. cities. Eight of the 25 big cities, in fact, did not show an increase. It should be noted that regional trends reflect not only the impact of the recession, but also the number of new enterprises and the degree of economic activity and competition.

Failures by Years in Business: Slightly more than half, 53.6 percent, of the commercial and industrial casualties during 1980 were in their first five years of operation. Ever since 1976, this percentage has held in the 53 to 54 percent range; it was slightly higher, 57 to 60, in the 1973-1975 time span. Neophyte concerns comprised the largest proportion of retail failures, about 61 percent, while veteran entrepreneurs with over ten years in operation ran highest in the manufacturing category, 23.9 percent.



It should be stressed that D&B tabulations show the age distribution of failing concerns; these statistics do not represent survival rates of new businesses, a frequent and widespread misinterpretation.

Causes of Bankruptcy: Whether the economy is healthy or ailing, managerial inexperience or ineptitude is cited as the underlying factor in nine out of ten business casualties. One-fifth of the retailers floundering in 1980 undertook to operate in lines in which they had no previous experience, and another one-sixth lacked any previous experience in management. As for the problems proving disastrous to the inexperienced or inept entrepreneurs, a growing portion of the bankruptcies were attributed to sales difficulties—not surprising as buying sagged during the 1980 recession. This increase hit all types of operations, but was particularly severe in the construction and retail segments. With inflation holding at double-digit levels, the percentage of businesses unable to cope with heavy operating expenses held at the prior year's high level. Also, with interest rates soaring, the portion of failures attributed to receivables problems held close to the decade-high percentage registered in the prior year.

Failures vs. Total Turnover: Failures do not represent total business discontinuances. As defined in Dun & Bradstreet's statistics, the failures comprise concerns involved in court proceedings or voluntary actions involving loss to creditors. An entrepreneur may discontinue operations for a variety of reasons, such as loss of capital, inadequate profits, ill health, retirement, etc., but if his creditors are paid in full, he is not tallied as a failure by the D&B definition. Failures comprise only a small percentage of total discontinuances, although they represent the most severe impact upon the economy and pinpoint the most vulnerable industries and locations in a specific time period. Every year, several hundred thousand firms are started, almost an equal number discontinued, and even more transfer ownership or control. Each business day, more than 5,000 changes are made in listings in the Dun & Bradstreet Reference Book; new names are added and discontinued businesses deleted, name styles altered, and credit and financial ratings revised up or down. This is all evidence of the dynamic change and turnover constantly taking place in the business population.

Rowena Wyant, Vice President
Business Economics Division
Dun & Bradstreet

Failures in 25 U. S. Cities*

1978-1980

City	1978 Number	1978 Liabilities (000)	1979 Number	1979 Liabilities (000)	1980 Numbers	1980 Liabilities (000)
New York, New York	444	$ 354,502	368	$ 207,742	311	284,732
Chicago, Illinois	102	45,718	101	72,250	108	23,798
Los Angeles, California	117	80,953	110	29,061	158	59,617
Philadelphia, Pennsylvania	93	396,516	87	30,382	119	55,558
Detroit, Michigan	35	10,917	49	12,342	60	24,286
Houston, Texas	72	47,436	100	39,118	172	159,685
Baltimore, Maryland	49	4,656	53	17,904	44	9,666
Dallas, Texas	89	50,642	103	55,714	102	37,722
Washington, D.C.	4	53,807	10	2,100	**	**
Cleveland, Ohio	29	9,118	25	15,754	9	4,580
Indianapolis, Indiana	45	8,633	34	5,650	51	12,109
Milwaukee, Wisconsin	25	5,170	19	2,178	25	12,283
San Francisco, California	44	40,307	49	48,512	40	16,875
San Diego, California	**	**	16	4,335	21	6,626
San Antonio, Texas	34	6,157	47	13,749	95	30,087
Boston, Massachusetts	28	3,605	23	30,891	42	54,104
Memphis, Tennessee	29	9,566	46	9,508	60	10,263
St. Louis, Missouri	8	625	4	106	11	5,759
New Orleans, Louisiana	16	17,388	25	18,425	29	26,795
Phoenix, Arizona	26	5,573	11	1,613	5	526
Columbus, Ohio	19	3,983	20	4,887	23	5,366
Seattle, Washington	37	9,877	40	6,514	122	40,368
Jacksonville, Florida	**	**	**	**	**	**
Pittsburgh, Pennsylvania	30	3,902	16	16,463	58	10,019
Denver, Colorado	11	1,725	24	10,134	44	14,440
Total 25 Cities	**1,388**	**$1,170,776**	**1,380**	**$ 655,332**	**1,709**	**$ 905,176**
Balance of Country	**5,231**	**$1,485,230**	**6,184**	**$2,012,030**	**10,033**	**$3,729,904**
Total United States	**6,619**	**$2,656,006**	**7,564**	**$2,667,362**	**11,742**	**$4,635,080**

* *These figures include City Area only*

** *Data incomplete*

Failure Trends by States*

Rate per 10,000 Listed Concerns—1940, 1977-80

Region & State	1940	1977	1978	1979	1980
New England					
Maine	61.6	25.9	13.2	33.3	45.6
New Hampshire	48.4	29.4	22.9	10.3	11.9
Vermont	28.8	16.6	8.4	8.7	7.1
Massachusetts	68.3	41.7	35.4	34.4	37.0
Connecticut	73.3	15.1	14.6	25.0	29.5
Rhode Island	65.6	11.4	21.3	6.1	13.7
Total New England	65.4	28.7	24.6	26.1	30.7
Middle Atlantic					
New York	168.3	38.1	28.6	23.8	28.8
New Jersey	78.3	63.6	53.1	53.9	53.6
Pennsylvania	54.7	38.4	31.6	34.1	50.2
Total Mid Atlantic	116.0	43.4	34.3	32.8	39.8
South Atlantic					
Maryland	37.1	79.3	27.3	38.1	37.2
Delaware	34.2	18.6	4.3	13.2	36.4
Dist. of Columbia	21.1	6.2	6.6	15.0	**
Virginia	62.7	24.7	23.3	32.3	52.3
West Virginia	26.3	19.3	12.4	10.4	24.8
North Carolina	44.7	3.8	9.4	18.1	34.2
South Carolina	30.9	9.0	3.3	3.3	**
Georgia	69.5	18.1	14.4	27.6	45.7
Florida	57.5	15.5	14.3	7.6	24.7
Total So. Atlantic	47.4	21.5	14.6	18.3	31.8
East North Central					
Ohio	39.0	18.1	26.6	30.0	44.4
Indiana	29.4	35.0	29.5	34.3	43.5
Illinois	76.7	37.3	34.3	33.1	58.0
Michigan	45.6	53.3	33.0	48.8	76.3
Wisconsin	44.5	17.6	20.9	30.8	39.1
Total E. No. Central	51.8	33.1	29.8	35.4	54.1
West North Central					
Minnesota	21.6	45.8	40.6	45.7	59.7
Iowa	28.1	17.8	21.3	22.4	29.5
Missouri	24.2	19.8	12.9	12.8	22.1
North Dakota	6.8	41.8	30.0	28.5	70.0
South Dakota	22.6	46.5	26.0	23.8	74.5
Nebraska	49.1	23.0	23.5	34.7	57.5
Kansas	19.9	23.3	24.0	39.1	51.8
Total W. No. Central	25.8	28.2	24.8	29.3	44.7
East South Central					
Kentucky	28.9	23.6	31.8	23.3	46.3
Tennessee	36.0	31.2	34.8	52.3	101.1
Alabama	31.0	34.3	28.5	30.6	45.2
Mississippi	36.3	8.7	12.3	13.4	38.8
Total E. So. Central	32.7	26.4	28.7	33.4	63.0
West South Central					
Arkansas	43.0	23.1	27.5	28.9	38.8
Oklahoma	45.4	43.9	47.4	33.4	69.0
Louisiana	13.6	7.7	27.6	34.4	31.9
Texas	27.1	26.2	32.3	42.6	57.5
Total W. S. Central	30.5	25.3	33.2	38.6	53.3
Mountain					
Montana	12.1	29.1	35.9	31.8	79.3
Idaho	34.8	21.3	23.9	30.1	49.5
Wyoming	41.7	3.2	4.7	5.7	2.6
Colorado	51.6	25.2	10.6	25.2	33.0
New Mexico	19.0	9.8	**	5.9	37.2
Arizona	43.4	31.6	25.0	11.2	6.3
Utah	54.1	3.4	2.7	5.7	15.7
Nevada	75.2	26.6	17.1	29.1	40.5
Total Mountain	40.0	21.2	14.7	18.3	30.2
Pacific					
Washington	44.9	71.7	54.8	76.6	177.8
Oregon	96.3	64.9	45.0	64.0	85.9
California	64.6	46.2	43.0	46.7	70.0
Total Pacific	65.0	49.4	43.8	51.2	85.6

* Data for Alaska and Hawaii not available prior to 1976; partial coverage from 1976.
** Data incomplete

Failures in Specific Retail & Manufacturing Lines

Rate per 10,000 Operating Concerns— 1980

Retail Lines Ranked by Failure Rates
1980

Lines of Business	Failure Rate Per 10,000 Operating Concerns
Infants & Children's Wear	58
Furniture & Furnishings	56
Sporting Goods	56
Women's Ready-to-Wear	53
Cameras & Photographic Supplies	49
Men's Wear	48
Appliances, Radio & TV	44
Lumber & Building Materials	36
Automobiles	36
Auto Parts & Accessories	33
Dry Goods & General Merchandise	31
Shoes	29
Eating & Drinking Places	26
Hardware	25
Books & Stationery	25
Gifts	23
Toys & Hobby Crafts	22
Bakeries	19
Jewelry	16
Groceries, Meats & Produce	15
Drugs	13
Department Stores	11
Women's Accessories	9

Manufacturing Industries Ranked by Failure Rates
1980

Lines of Business	Failure Rate Per 10,000 Operating Concerns
Furniture	105
Transportation Equipment	102
Textiles	79
Leather & Shoes	61
Apparel	58
Electrical Machinery	52
Rubber & Fabricated Plastic Products	45
Metals, Primary & Fabricated	43
Lumber	38
Chemicals & Drugs	36
Printing & Publishing	34
Stone, Clay & Glass	33
Machinery, except Electrical	33
Food	29
Paper	29

Failure Distribution by Liability Size

1945-80

	Under $5,000		$5,000 to $25,000		$25,000 to $100,000		$100,000 to $1 Million		Over $1 Million	
	No.	%	No.	%	No.	%	No.	%	No.	%
1945	270	33.4	343	42.4	146	18.0	45	5.6	5	0.6
1946	263	23.3	488	43.2	252	22.3	119	10.6	7	0.6
1947	600	17.3	1,661	47.8	842	24.2	350	10.1	21	0.6
1948	846	16.1	2,799	53.3	1,208	23.0	374	7.1	23	0.5
1949	1,915	20.7	4,646	50.3	2,147	23.2	520	5.6	18	0.2
1950	2,065	22.5	4,706	51.4	1,975	21.6	407	4.4	9	0.1
1951	1,832	22.7	4,160	51.6	1,634	20.3	412	5.1	20	0.3
1952	1,428	18.8	3,884	51.0	1,769	23.3	512	6.7	18	0.2
1953	1,383	15.6	4,317	48.7	2,375	26.8	748	8.5	39	0.4
1954	1,640	14.8	5,640	50.9	2,946	26.5	829	7.5	31	0.3
1955	1,785	16.3	5,412	49.3	2,916	26.6	820	7.5	36	0.3
1956	2,032	16.0	6,152	48.4	3,431	27.1	1,022	8.1	49	0.4
1957	2,001	14.6	6,699	48.8	3,847	28.0	1,147	8.3	45	0.3
1958	2,028	13.5	7,015	46.9	4,456	29.8	1,408	9.4	57	0.4
1959	1,841	13.1	6,664	47.4	4,202	29.9	1,284	9.1	62	0.5
1960	1,688	10.9	6,884	44.6	5,078	32.9	1,703	11.0	92	0.6
1961	1,903	11.1	7,378	43.2	5,725	33.5	1,973	11.6	96	0.6
1962	1,647	10.4	6,700	42.5	5,425	34.4	1,876	11.9	134	0.8
1963	1,296	9.0	5,781	40.2	5,115	35.6	2,031	14.1	151	1.1
1964	1,093	8.1	5,202	38.5	5,051	37.4	2,003	14.9	152	1.1
1965	1,007	7.5	5,067	37.5	5,266	39.0	2,005	14.8	169	1.2
1966	932	7.1	4,569	35.0	5,332	40.8	2,042	15.7	186	1.4
1967	814	6.6	4,434	35.9	4,896	39.6	2,045	16.5	175	1.4
1968	481	5.0	3,332	34.6	4,016	41.7	1,686	17.5	121	1.2
1969	416	4.6	3,000	32.8	3,776	41.2	1,807	19.7	155	1.7
1970	430	4.0	3,197	29.7	4,392	40.9	2,450	22.8	279	2.6
1971	392	3.8	2,806	27.2	4,413	42.7	2,423	23.5	292	2.8
1972	394	4.1	2,497	26.1	4,149	43.4	2,236	23.4	290	3.0
1973	285	3.0	2,434	26.1	3,908	41.8	2,375	25.4	343	3.7
1974	304	3.1	2,150	21.7	4,279	43.1	2,755	27.8	427	4.3
1975	292	2.5	2,226	19.5	4,986	43.6	3,459	30.3	469	4.1
1976	122	1.3	1,750	18.2	4,304	44.7	3,029	31.4	423	4.4
1977	102	1.3	1,283	16.2	3,476	43.9	2,708	34.2	350	4.4
1978	76	1.2	928	14.0	2,708	40.9	2,593	39.2	314	4.7
1979	62	0.8	954	12.6	2,914	38.5	3,216	42.5	418	5.6
1980	72	0.6	1,243	10.6	4,367	37.2	5,417	46.1	643	5.5

Commercial and Industrial Failures

by 43 Divisions of Industry—1940, 1950, 1960, 1970, 1975-1980

Line of Industry	1940 Number	1940 Liabilities (000)	1950 Number	1950 Liabilities (000)	1960 Number	1960 Liabilities (000)	1970 Number	1970 Liabilities (000)
Mining And Manufacturing								
Mining—Coal, Oil, Miscellaneous	77	$ 9,146	28	$ 3,335	98	$ 19,650	54	$ 58,046
Food and Kindred Products	400	14,022	261	16,225	173	31,276	106	92,692
Textile Mill Products and Apparel	611	10,975	420	14,909	435	36,274	311	105,520
Lumber and Lumber Products	304	6,311	312	11,295	520	38,292	207	42,517
Paper, Printing and Publishing	237	5,664	112	5,396	200	12,084	203	32,219
Chemicals and Allied Products	122	2,706	56	5,601	63	5,662	69	31,753
Leather and Leather Products	108	2,018	103	4,106	82	12,786	43	9,412
Stone, Clay and Glass Products	34	1,258	66	2,940	44	4,000	57	10,250
Metals, Primary and Fabricated	161	3,844	163	8,264	286	42,635	210	111,526
Machinery	117	3,016	209	10,330	289	44,682	364	204,200
Transportation Equipment	40	2,764	62	3,772	133	16,854	131	34,576
Miscellaneous	244	5,075	284	8,921	289	25,340	280	84,130
Total Mining and Manufacturing	2,455	66,799	2,074	95,094	2,612	289,635	2,035	817,841
Wholesale Trade								
Food and Farm Products	487	7,651	277	11,214	321	29,318	160	39,674
Apparel	81	1,101	39	1,336	48	3,513	29	6,288
Dry Goods	54	506	26	600	35	1,403	26	11,831
Lumber, Building Materials, Hardware	117	2,899	104	4,424	184	14,040	98	17,657
Chemicals and Drugs	53	498	43	971	45	1,626	49	5,578
Motor Vehicles and Auto Equipment	67	902	71	1,732	116	7,404	105	9,186
Electrical Goods	46	601	47	1,895	83	7,537	54	15,353
Furniture and Furnishings	52	754	27	733	79	6,176	52	10,350
Machinery, Equipment and Supplies	111	1,627	147	3,185	221	12,298	184	24,930
Miscellaneous	248	3,866	235	7,504	343	23,841	229	38,184
Total Wholesale Trade	1,316	20,405	1,016	33,594	1,473	107,156	984	179,041
Retail Trade								
Food and Liquor	2,547	12,074	941	10,297	1,059	28,557	533	38,983
General Merchandise	533	4,478	208	4,664	255	12,844	128	14,029
Apparel and Accessories	1,590	10,647	735	12,927	978	25,753	525	29,105
Furniture, Home Furnishings	537	4,852	462	9,943	968	38,782	602	52,318
Lumber, Building Materials, Hardware	439	4,363	260	4,936	487	20,063	200	19,961
Automotive Group	594	4,738	437	6,639	1,338	49,944	1,029	75,075
Eating and Drinking Places	1,219	9,616	831	15,020	1,426	41,589	940	80,936
Drug Stores	518	3,526	116	1,714	168	5,817	113	7,932
Miscellaneous	518	3,819	439	6,551	709	17,745	580	42,254
Total Retail Trade	8,495	58,115	4,429	72,691	7,386	241,094	4,650	360,603
Construction								
General Building Contractors	197	5,263	282	9,235	1,020	110,656	659	122,713
Building Sub-contractors	529	6,043	588	14,407	1,419	74,177	905	82,818
Other Contractors	34	2,005	42	2,009	168	16,536	123	25,002
Total Construction	760	13,311	912	25,651	2,607	201,369	1,687	231,533
Commercial Service								
Passenger and Freight Transportation	157	2,400	187	6,371	410	38,356	375	107,007
Miscellaneous Public Services	6	44	36	2,009	62	3,874	83	14,320
Hotels	38	1,307	29	1,948	82	23,271	40	9,952
Cleaning, Dyeing, Repairing	133	1,219	93	2,247	122	3,381	87	5,815
Laundries	55	965	47	1,010	68	2,459	35	3,721
Funeral Services	32	405	10	200	7	172	6	166
Other Personal Services	70	357	57	659	81	3,583	140	5,968
Business Services	44	1,060	119	3,229	266	19,260	463	146,148
Repair Services	58	297	151	3,580	269	5,000	163	6,039
Total Commercial Service	593	8,054	731	21,253	1,367	99,376	1,392	298,736
Total United States	**13,619**	**$166,884**	**9,162**	**$248,283**	**15,445**	**$938,630**	**10,748**	**$1,887,754**

1975		1976		1977		1978		1979		1980	
Number	Liabilities (000)	Number	Liabilities (000)	Number	Liabilities (000)	Number	Liabilities (000)	Number	Liabilities (000)	Number	Liabilities (000)
28	$ 9,465	37	$ 105,992	30	$ 42,155	38	$ 156,265	$ 65	72,963	95	$ 168,759
83	187,330	75	52,770	64	49,918	75	77,877	66	67,231	69	57,127
292	112,901	196	220,659	175	522,436	134	96,451	162	125,077	185	143,327
222	84,317	182	148,547	112	36,003	131	102,572	136	59,342	216	64,393
208	45,930	175	50,419	132	32,463	139	41,579	146	34,240	160	89,604
43	52,800	32	27,150	37	28,005	29	25,016	38	126,246	41	23,508
31	19,066	15	4,714	20	16,557	14	37,757	7	9,078	17	12,194
36	19,735	46	139,105	37	10,712	38	20,109	29	28,579	54	18,569
121	67,471	112	54,127	93	178,668	93	67,655	83	74,501	164	142,565
253	250,073	224	132,071	173	122,789	129	128,543	187	198,224	219	144,847
85	32,725	65	144,941	50	27,209	37	18,184	55	49,755	92	835,451
247	138,796	201	41,257	199	154,207	157	105,719	191	124,940	278	184,673
1645	1,020,609	1,380	1,121,722	1,122	1,221,122	1,013	878,727	1,165	970,178	1,599	1,865,017
178	64,490	169	48,554	132	39,268	127	83,540	148	90,772	190	98,158
38	12,162	41	3,716	27	6,585	19	5,848	33	7,386	34	9,882
45	101,530	27	9,003	37	22,637	19	20,396	25	29,899	41	40,635
102	35,904	114	63,647	66	13,458	70	28,662	81	24,405	117	54,231
33	6,515	46	20,299	23	10,892	35	29,450	29	15,338	43	15,881
100	18,424	87	35,547	73	208,786	57	9,118	70	57,555	155	63,713
63	15,491	62	26,842	94	42,012	58	38,925	62	28,974	85	21,705
64	13,459	60	11,959	37	25,853	42	11,551	32	14,284	55	22,764
208	59,894	155	76,054	150	154,102	115	28,033	176	60,726	269	139,051
258	79,454	267	118,139	248	89,126	198	107,027	252	91,914	295	124,893
1,089	407,323	1,028	413,760	887	612,729	740	345,770	908	421,253	1,284	590,913
481	81,595	417	46,007	374	69,709	326	417,853	307	122,578	431	58,230
171	1,177,621	132	50,822	101	25,590	98	35,702	76	19,780	128	70,813
719	96,830	582	61,193	473	46,774	398	38,485	428	73,355	597	128,743
698	117,163	530	88,937	444	63,660	389	48,751	465	80,132	712	108,867
234	39,579	221	49,255	168	24,281	144	27,734	156	32,867	240	46,748
733	127,398	620	68,997	520	83,039	429	68,035	501	84,660	983	257,286
874	114,686	779	99,982	606	81,579	515	73,111	633	132,264	948	192,554
113	11,895	109	11,250	88	8,782	80	14,231	63	6,902	66	9,043
776	69,141	749	80,469	632	79,148	510	53,548	554	84,321	805	121,255
4,799	1,835,908	4,139	556,912	3,406	482,560	2,889	777,450	3,183	636,859	4,910	993,539
942	461,987	716	261,613	608	168,926	508	145,643	631	147,287	1,071	334,908
1,202	142,039	940	137,049	764	209,126	631	140,359	687	102,511	1,164	333,333
118	36,819	114	30,075	91	42,168	65	42,376	60	41,525	120	83,868
2,262	640,845	1,770	428,737	1,463	420,220	1,204	328,378	1,378	291,323	2,355	752,109
419	81,871	384	98,211	299	173,708	250	167,784	274	165,499	514	189,453
18	3,755	11	6,033	6	1,395	12	2,639	13	5,152	24	7,468
112	188,361	82	115,683	62	83,258	31	24,788	25	22,402	59	43,042
65	4,158	44	2,929	36	1,983	32	2,991	26	2,101	38	6,270
46	4,178	33	3,284	18	2,551	14	4,231	9	1,428	17	2,881
7	2,861	8	616	5	771	5	436	8	569	10	1,775
112	7,622	104	5,136	79	4,364	51	4,405	79	11,751	140	12,198
664	173,133	514	251,242	408	82,313	286	106,027	383	129,934	609	131,339
194	9,546	151	7,006	128	8,343	92	12,380	113	8,913	183	19,076
1,637	475,485	1,331	490,140	1,041	358,686	773	325,681	930	347,749	1,594	413,502
11,432	$4,380,170	9,628	$3,011,271	7,918	$3,095,317	6,819	$2,656,006	7,564	$2,667,362	11,742	4,635,080

Age of Failed Businesses

by Function— 1980

Age in Years	Manu-facturing	Wholesale	Retail	Construction	Service	All Concerns
One Year or Less	0.7%	0.9%	1.1%	0.5%	1.3%	0.9%
Two	8.3	8.5	11.7	5.3	11.2	9.6
Three	14.6	13.4	18.2	11.1	14.6	15.3
Total Three Years or Less	23.6	22.8	31.0	16.9	27.1	25.8
Four	12.3	16.1	16.6	15.7	14.2	15.4
Five	11.4	11.5	13.3	12.8	10.6	12.4
Total Five Years or Less	47.3	50.4	60.9	45.4	51.9	53.6
Six	9.3	8.6	8.7	9.5	8.6	8.9
Seven	6.7	5.9	5.5	7.9	6.8	6.3
Eight	4.8	5.5	4.7	6.2	5.8	5.2
Nine	5.0	4.4	3.1	5.4	5.4	4.3
Ten	3.0	4.3	2.9	4.1	3.1	3.4
Total Six-Ten Years	28.8	28.7	24.9	33.1	29.7	28.1
Over Ten Years	23.9	20.9	14.2	21.5	18.4	18.3
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Number of Failures	1,599	1,284	4,910	2,355	1,594	11,742

Failure Age Trend

1950-80

Year	% In Business 5 Years or Less	% In Business 6 to 10 Years	% In Business Over 10 Years
1950	68.2	19.0	12.8
1951	63.2	23.5	13.3
1952	59.9	25.8	14.3
1953	58.5	26.7	14.8
1954	57.2	27.3	15.5
1955	58.6	26.0	17.4
1956	58.6	23.1	18.3
1957	58.9	21.8	19.3
1958	57.2	21.4	21.4
1959	57.1	22.3	20.6
1960	58.6	20.8	20.6
1961	56.2	22.4	21.4
1962	55.4	22.2	22.4
1963	55.4	21.7	22.9
1964	56.0	21.5	22.5
1965	56.9	21.4	21.7
1966	57.4	21.5	21.1
1967	55.3	22.5	22.2
1968	53.9	23.3	22.8
1969	53.2	24.4	22.4
1970	54.9	22.7	22.4
1971	54.2	22.2	23.6
1972	55.7	22.4	21.9
1973	57.0	22.4	20.6
1974	59.9	20.8	19.3
1975	57.4	22.7	19.9
1976	54.8	26.0	19.2
1977	53.1	27.5	19.4
1978	53.2	27.4	19.4
1979	54.5	27.0	18.5
1980	53.6	28.1	18.3

Causes of 11,742 Business Failures in 1980

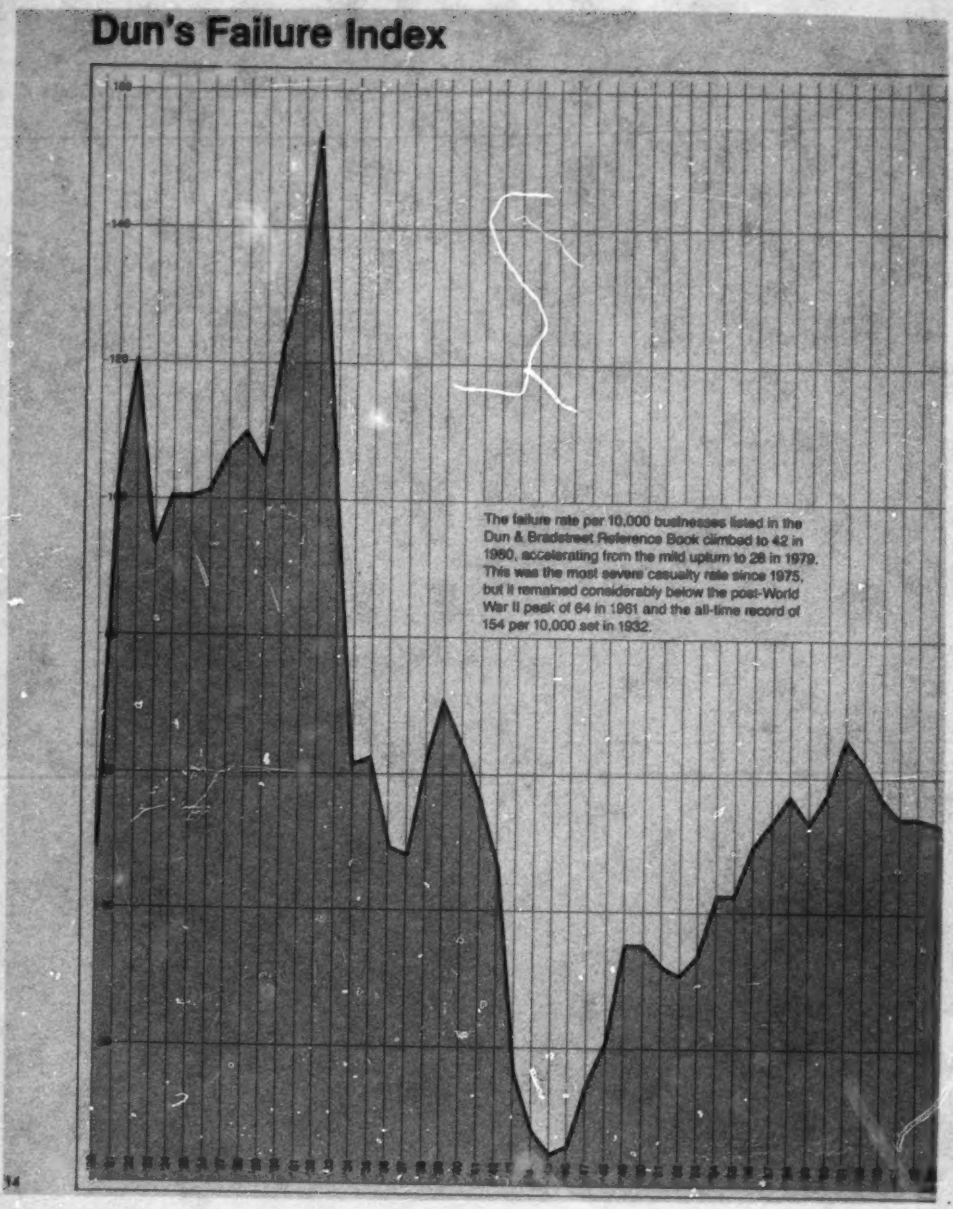
Classification of Failures Based on Opinions of Informed Creditors and Information in Dun & Bradstreet Reports.

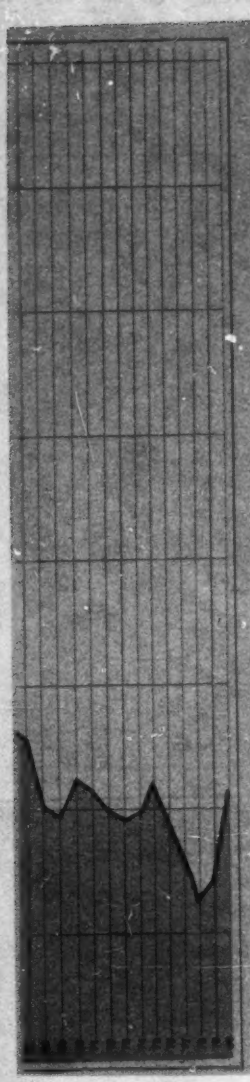
Underlying Causes	Total					
Neglect	0.8	1.1	0.9	0.9	0.5	0.8
Fraud	0.2	0.9	0.3	0.4	0.3	0.4
Lack of Experience in the Line	12.7	12.9	18.2	9.9	19.2	14.9
Lack of Managerial Experience	14.2	14.6	16.1	16.5	19.2	16.1
Unbalanced Experience*	18.9	21.8	19.6	18.9	20.5	19.7
Incompetence	49.2	44.5	40.6	49.7	41.1	44.1
Disaster	0.6	0.4	0.5	0.6	0.6	0.5
Reason Unknown	3.4	4.0	2.8	3.1	5.7	3.5
Total	100.0	100.0		100.0	100.0	100.0
Number of Failures	1,599	1,284	4,910	2,355	1,594	11,742
Average Liabilities Per Failure	$1,178,872	$480,213	$302,250	$319,587	$282,708	$394,744

*Inexperience and lack knowledge in certain functions, such as production, on the part of the individual in many businesses, or of the management as a whole, constituting a management unit.

Apparent Causes		Percent					
Due to	Bad Habits	0.4	0.2	0.2	0.4	0.2	0.3
	Poor Health	0.3	0.3	0.5	0.5	0.3	0.4
	Marital Difficulties	—	0.1	0.1	0.0	—	0.0
	Other	0.1	0.5	0.1	—	0.1	0.1
On the part of the principals, affected by	Misleading Name	—	—	—	0.0	—	0.0
	False Financial Statement	0.1	0.1	0.1	0.2	0.1	0.1
	Premeditated Overbuy	—	0.1	—	—	—	0.0
	Irregular Disposal of Assets	0.1	0.5	0.1	0.2	0.1	0.2
	Other	—	0.2	0.1	—	0.1	0.1
Evidenced by inability to avoid conditions which resulted in	Inadequate Sales	57.8	56.9	61.9	60.2	56.3	59.6
	Heavy Operating Expense	35.8	29.2	24.6	27.7	35.4	28.9
	Receivables Difficulties	15.5	15.8	4.0	13.4	8.7	9.4
	Inventory Difficulties	8.0	13.7	14.5	2.0	1.7	9.3
	Excessive Fixed Assets	2.8	1.6	2.9	2.4	5.9	3.1
	Poor Location	1.0	1.3	3.7	0.2	1.2	2.0
	Competitive Weakness	20.3	21.0	24.8	23.5	23.0	23.3
	Other	2.0	0.8	1.2	1.4	1.5	1.3
Some of these occurrences could have been provided against through insurance	Fire	0.4	0.3	0.3	—	0.1	0.2
	Flood	—	—	0.0	0.2	0.1	0.1
	Burglary	—	—	0.1	—	—	0.0
	Employees' Fraud	—	—	—	—	0.1	0.0
	Strike	0.1	—	—	0.0	—	0.0
	Other	0.1	0.1	0.1	0.4	0.1	0.2
	Percent Of Total Failures	13.0	10.9	41.8	20.1	13.6	100.0

Because some failures are attributed to a combination of apparent causes, the totals of these columns exceed the totals of the corresponding columns on the left.


Dun's Failure Index
160
140
120
The failure rate per 10,000 businesses listed in the Dun & Bradstreet Reference Book climbed to 42 in 1980, accelerating from the mild upturn to 28 in 1979. This was the most severe casualty rate since 1975, but it remained considerably below the post-World War II peak of 64 in 1961 and the all-time record of 154 per 10,000 set in 1932.



Business Failures include those businesses that ceased operations following assignment or bankruptcy; ceased with loss to creditors after such actions as execution, foreclosure or attachment; voluntarily withdrew leaving unpaid obligations; were involved in court actions such as receivership, reorganization or arrangement; or voluntarily compromised with creditors.

Liabilities as used in this publication, refer to current liabilities, and have a special meaning: they include all accounts and notes payable and all obligations, whether in secured form or not, known to be held by banks, officers, affiliated companies, supplying companies or the government. Long-term, publicly-held obligations are not included and offsetting assets are not taken into account.

Total Listed Concerns represent the total number of business enterprises listed in the Dun & Bradstreet Reference Book. This Book includes manufacturers, wholesalers, retailers, building contractors and certain types of commercial services including public utilities, water carriers, motor carriers and airlines. This count by no means covers all the business enterprises of the country. Specific types of business not listed are: financial enterprises including banks, mortgage, loan and investment companies; insurance and real estate companies; railroads; terminals; amusements; and many small one-man services. Neither the professions nor farmers are included.

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SBA

U.S. Small Business Administration
Washington, DC 20416

Memorandum

Date: March 29, 1982

From: Frank S. Swain, Chief Counsel for Advocacy

Subject: The State of Small Business: Recent Business Failure Statistics

To: James C. Sanders, Administrator

Much has been written recently concerning small business bankruptcy and failures. There will never be a very exact or very current measure of business failure, because, except in the case of formal bankruptcy, there is no requirement of notification of any government or private group.

Business failure statistics issued by the Dun and Bradstreet Corporation for the first nine weeks of 1982 indicate that business failure rates are up almost 50% over the rates for a similar period in 1981.

The Dun and Bradstreet numbers are based on a continuing review of approximately 2.8 million firms. Business failures are defined as:

1. ceasing operations following assignment or bankruptcy;
2. ceased with loss to creditors after such action as execution, foreclosure or attachment;
3. voluntarily withdrew leaving unpaid obligations;
4. involvement in court actions such as receivership, reorganization, or arrangement;
5. or voluntarily compromised with creditors.

The only other routinely available general indicator of business failures is the monthly count of bankruptcies issued by the Administrative Office of the U.S. Courts. This indicator is only up 7.5% for December, 1981 and January, 1982 compared to December, 1980 through February, 1981. (February, 1982 figures are not yet available from the Administrative Office of the U.S. Courts). In contrast, the Dun and Bradstreet index grew 47% from December, 1981 through the first week of March, 1982 compared to the similar period of 1980 and 1981. (See Table 1 and Chart 1).

Although the Dun and Bradstreet numbers are based on a sample of U.S. business, and the U.S. Courts numbers represent a complete count of the universe of bankruptcies, the Dun and Bradstreet numbers are probably more representative of real world conditions. Bankruptcy

represents only one way in which a business can exhibit failure; Dun and Bradstreet measures alternative ways of failing. Dun and Bradstreet also correlates data from a number of sources. For at least the last three years the Dun and Bradstreet sample has been relatively stable. This stability, plus relative stability of methods (as claimed by Dun and Bradstreet) should produce a meaningful index of change.

The number of bankruptcies is a more difficult index to evaluate. The major change in U.S. Bankruptcy law which occurred in October, 1979 should have made the count more meaningful. The new Federal law was intended to simplify bankruptcy procedures and provide a uniform basis for filing across all states. But, the bill included a provision which allowed states to amend the Federal provisions, if they so desired. A number of states have done so over the past three years. Each change must be examined to determine its impact on the total number of bankruptcies.

Both the Business Failures Index and the Bankruptcy Listing have moved in the same direction recently, but not to the same extent.

	79/80	80/81	81/82
Average number of bankruptcies (Dec., Jan., and Feb., except 81/82 which is Dec. and Jan.)	2716	3794	4078
Change in average number of bankruptcies		+40%	+7.5%
Number of business failures recorded by D&B for 16 week period ending with the last week of March	2776	4323	6408
Percentage change		+55.7%	+48.2%

Although the change in bankruptcies was greater between 1979/1980 and 1980/1981 for the Bankruptcy Index, the absolute changes in business failures noted by Dun and Bradstreet was larger in the 1981/1982 period even though the percentage change fell from a 56% increase to a 48% increase. We believe that the Dun and Bradstreet information should be looked at as more meaningful in this case. We believe they do signal a major shift in the trend line of bankruptcies which may be with us for most of the remainder of calendar year 1982. A review of Table 2 and Chart 2, which shows the Dun and Bradstreet data smoothed through the use of five week moving averages will show the trend lines clearly. If even one more month of U.S. Courts data was available (February) we would have at least two observations on the bankruptcy data to see if it has shifted up more than the 7.5% observed in December and January. This data will probably not be available for several weeks, however.

Based on the current information the Dun and Bradstreet numbers would extrapolate to a total of approximately 27,000 business failures among a population of slightly more than 3,000,000 businesses. U.S. Court bankruptcy numbers have been running in the range of approximately 50,000 per year during 1980 and 1981. These numbers will probably shift upward in 1982 but with only one month of data available it is impossible to extrapolate meaningfully at this time. Bankruptcies among small firms traditionally lag a recovery by up to six months.

It is very important to note that these increasing failure statistics are not adjusted for business growth. It is impossible to absolutely compare growth and failure, for very recent time periods, because there is no good information. However, it is safe to say that new business formation continues to be greater than all combinations of business failures. For the most recent month available, Dun and Bradstreet reports a five percent increase in the number of incorporations from October to November, 1981.

TABLE 1

Business Failures (Weekly Data)
1979-1982 Selected Weeks

	1979/1980	1980/1981	1981/1982
December	180	282	367
	129	195	391
	72	212	216
	63	174	177
January	189	250	314
	212	344	456
	154	293	438
	149	221	374
February	177	372	449
	223	321	529
	142	232	505
	169	236	459
March	211	345	420
	174	319	454
	238	291	448
	294	236	411
	2776	4323	6408
		+55.7%	+48.2%

CHART 1

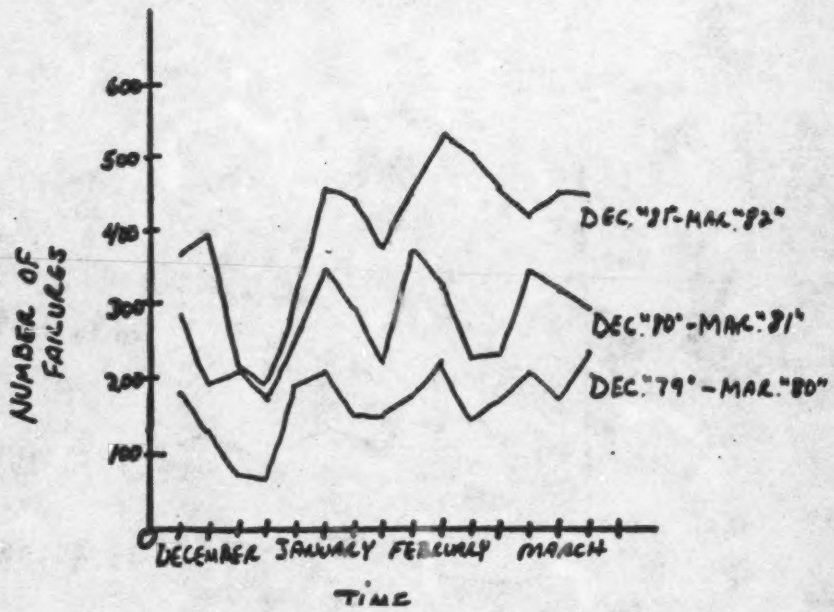
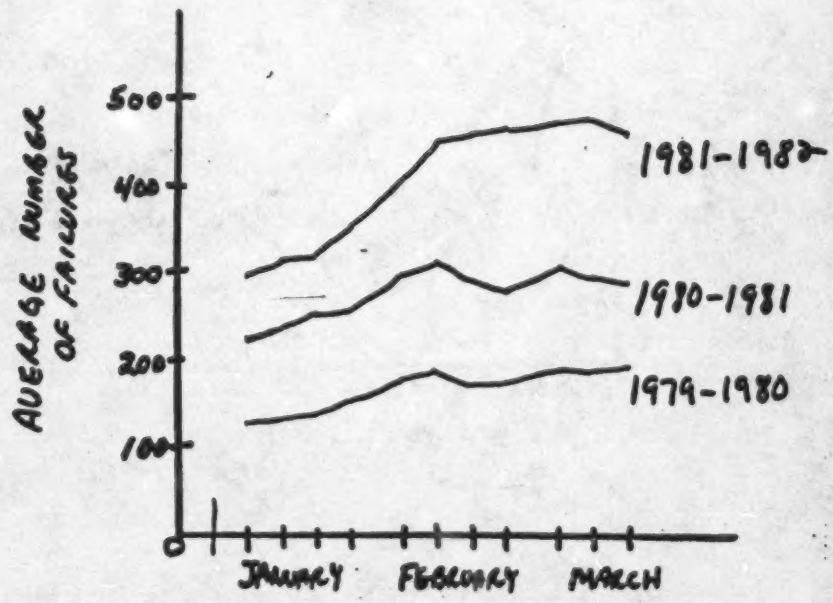


TABLE 2

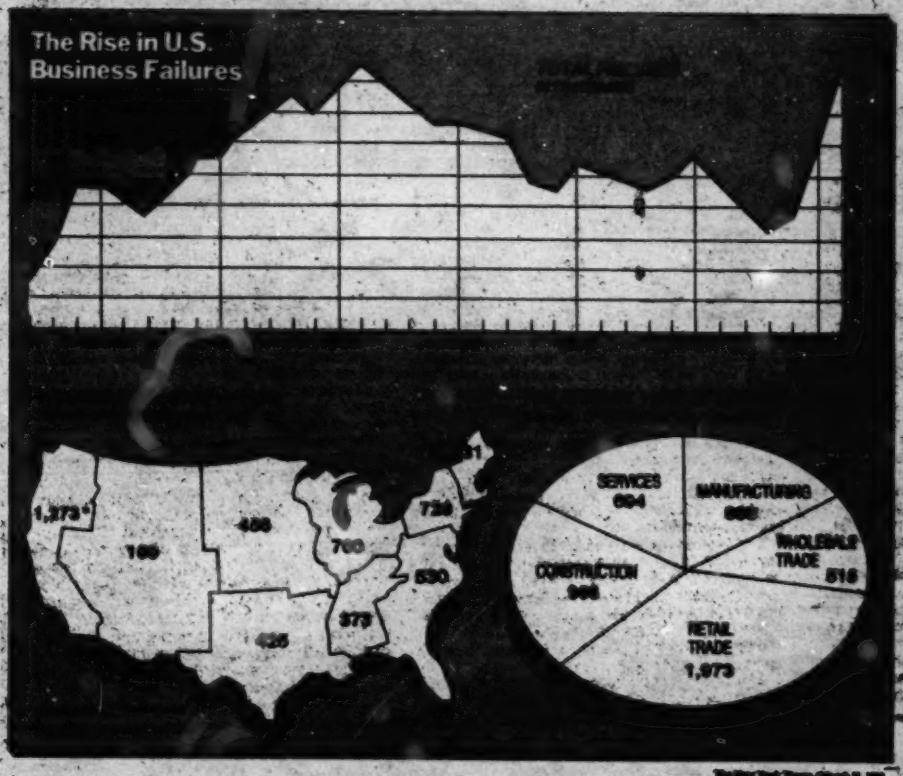
Business Failures
Five Week Moving Average
1979-1982 Selected Weeks

	1979/1980	1980/1981	1981/1982
January	126.6	222.6	293.0
	133.0	235.0	310.8
	138.0	254.6	320.2
	153.4	256.4	351.8
February	176.2	296.0	406.2
	183.0	310.2	449.2
	169.0	287.8	459.0
	172.0	276.4	463.2
March	184.4	301.2	472.4
	183.8	290.6	473.4
	186.8	284.6	457.2
	217.2	285.4	438.4

CHART 2



The New York Times March 31, 1982



Business Failures Spreading

Rate Is Called The Highest Since 1932

Continued From First Business Page

tion, an increase of more than 30 percent from the total for the first 11 weeks of 1981. For the Middle Atlantic region, which includes New York, the increase is 69 percent.

Inevitably, those companies that have filed for shelter under Chapter 11 or been liquidated under Chapter 7 of the Federal Bankruptcy Act say that high interest rates and a deepening recession are the primary culprits. Capital expenditures are down; inventories are more costly to maintain, and their repayments are harder to meet.

"The Dun & Bradstreet figures also confirm a new and disturbing trend," said Jerry Jasinowski, chief economist for the National Association of Manufacturers. "Namely, that the mid-New cutback has reached the level of the durable goods manufacturer."

Indeed, according to the Dun & Bradstreet report, the failure rate among manufacturing concerns was up 31.3 percent — from 440 to 886 — from the comparable period last year. Retail business failures, while accounting for a much larger portion of the overall failure total, increased at a slower rate. Some 1,970 have failed since Jan. 1, up 44.7 percent from the 1,361recorded for the period last year.

Wholesalers, however, have suffered the largest rate of failures this year, up 60.8 percent.

"Businesses traditionally operate at extremely thin margins," said Ron Richardson, vice president of the National Association of Wholesaler-Distributors. "In a recession, people tend to slow down their rate of payment." That, along with the high cost of maintaining an inventory — which is a wholesaler's chief asset — is the thing that's putting such tremendous pressure on the system.

The service industry has also been hard-hit this year, with failures up almost 50 percent, while the public utilities industry totaled a 40.2 percent increase in failures.

Geographically, there has been no letup in the failure rate. The mid-Atlantic region, with outstanding [illegible] Jersey, Delaware, North and South Dakota, Pennsylvania, Kansas, Oklahoma, the [illegible] up more than 60 percent from last year, while Colorado, Texas, Louisiana, Wyoming, Arizona and Alaska, [illegible] up 22.9 percent.

[illegible] that the failure rate, although steeply higher in a recession, is still small in long-term [illegible] "Most failures also [illegible] at plateau about the middle of last year," said Leonard E.B. Andrews, editor and publisher of the National Bankruptcy Reporter, a newsletter. "We really haven't seen an increase since then, just it's still hanging in there, that's for sure."

Real Estate Severely Affected

According to Mr. Andrews, whose publication only follows companies that earn more than $100,000 a year, real estate-related businesses have shown the greatest recent failure increase. He said about 35 percent of all failures this year have been in that area.

"The thing you have to remember, however, is that bankruptcy doesn't necessarily mean a business is destroyed," said Roger C. Kormendi, an associate professor at the University of Chicago's graduate school of economics. "In many cases, it's just a cash loss on the part of the business owner. Assets don't disappear overnight."

For example, if Chrysler went bankrupt, "its owners would obviously take a large capital loss, but the company's plants would not be destroyed," Dr. Kormendi said, adding, "They'd be sold to people like Toyota."

Indeed, according to Dr. Kormendi, an economy could be very healthy and still have a high business failure rate. "Economies evolve," he said, "and in many cases a business failure simply means a reallocation of assets. You have to print those figures with a great deal of respect."

But in many other cases, of course, a business failure means a great deal of pain in lost wages, lost savings and lost hopes.

At Hirt's Motor Transport Lines, a Chicago-based carrier of iron and steel products, a Chapter 11 filing has meant a 60 percent cutback in drivers, Tony Rinkevich, vice president of traffic, said that some of the problems could not be measured on a ledger sheet. "There's a certain negative attitude when you file Chapter 11," he said. "Other companies don't want to do business with you. They're afraid of you."

Some analysts see other hidden factors in the failure rate. Francis A. Lees, a professor of finance at St. John's University, believes the rise in business failures is at least partly a reflection of the overall deterioration of debt quality in American business.

Dr. Lees, whose study of corporate debt is scheduled to be published by the Conference Board, the business research group, later this year, said a survey of 36 large and medium-sized corporations showed that almost all had increased the ratio of debt to assets from 1970 to 1981. Moreover, he said, profitability ratios were generally down, while interest costs were up.

"It's not easy to link what's happening directly to business failure statistics," he said. "I think it's partly the recession, and partly other factors. We may be experiencing a long-cycle effect, and not just a one-year recessionary effect."

Wall Street Journal, May 21, 1982.

Ripple Effects

Harvester's Woes Take A Heavy Toll on Those Serving Troubled Firm

Employes Are Cast Adrift, Dealers' Sales Run Dry; Small Suppliers in Danger

Bankruptcy Rumors Denied

By Meg Cox
Staff Reporter of The Wall Street Journal

FORT WAYNE, Ind.—If International Harvester Co. pulls the plug, Larry Redman says he may go down the drain.

Challenge Tool & Manufacturing Co., which Mr. Redman owns, sold $2 million of parts in 1981, and 70% of them went to Harvester truck plants here and in Springfield, Ohio. "If they file for Chapter 11 bankruptcy when they owe us a lot of money," the soft-spoken Harvester engineer says, "We'll file bankruptcy too. We're really sweating whether the check they gave us Tuesday will clear."

Mr. Redman is one of thousands of creditors, dealers and employes who wait queasily while debt-laden Harvester tries to avoid a plunge into bankruptcy. If this humpty-dumpty falls, they will be the ones with egg on their faces.

Rumors of an imminent bankruptcy filing yesterday sent Harvester's stock plunging to $3.25, down $1.375 from Wednesday, on heavy volume. Harvester strongly denied that a bankruptcy filing was imminent but reported a second quarter loss of $198.4 million, more than double the year-earlier deficit (see story on page 31).

Heavy Toll

The miseries of the giant maker of trucks and farm and construction equipment have already taken a heavy toll, and the recession has deepened the suffering. Laid-off Harvester workers have difficulty finding new jobs, dealers go out of business, and suppliers can't find alternative markets to fill in gaps left by Harvester's decline.

The company's woes even touch its bankers, although none appear threatened with failure resulting from potential losses on Harvester's $4.2 billion debt. "I eat, sleep and breathe Harvester now," says the American representative of one foreign bank. "It's an emotional thing with me. I made this loan, and I'm damned if I'll let it die."

For many people, however, more than a reputation will be lost if Harvester dies or goes comatose for a while.

Suppliers

More than 5,000 suppliers sell Harvester everything from glass, steel and paint to diesel engines, tractor seats and steering wheels. Some, like Rockwell International Corp., are giant global manufacturers who will barely twitch if Harvester goes under. But many are small, private outfits like Challenge Tool, which peddles fuel caps, clutch-release yokes and other truck parts to Harvester. Their fates may hinge on Harvester's.

Some, like Fort Wayne-based DPS Inc., feel they can survive the slump and take their losses stoically. "I've made a good living off Harvester," says owner David Schenkel, "and if I have to sacrifice a year or two of profits to help them, it's worth it."

But Larry Redman and his Challenge Tool don't have a year or two to wait. In the past two years, he estimates, the equity in his business dropped 50%, to about $180,000. That, the 39-year-old businessman adds, represents his entire retirement fund.

"I worry about Harvester maybe 20 hours a day," he says. Harvester currently owes him $120,000. "The instant loss of that much cash flow would kill us."

To cut his potential losses, Mr. Redman started shipping loads to Harvester ten times monthly instead of one large monthly delivery. If the company declares Chapter 11, he explains, Redman will have less to lose in unpaid bills.

Mr. Redman's new shipping policy grew out of painful experience. Challenge Tool sustained a loss of $18,000 when White Motor Co. filed for bankruptcy in 1980. "Which to us is a bunch of money," he says.

This time, of course, the stakes are higher. It's a precarious position for a man who left a seemingly safe engineering job at Harvester a decade ago for the sweet freedom of his own enterprise. In that time, his business has grown steadily, as evidenced by the varied shades of brown paint on several additions to his original steel building. To reduce his total dependency on Harvester, he pursued business in the rail-car and medical-supplies industries, as well as from other farm-equipment makers. By 1979, he had whittled Harvester to just 40% of sales, toward a goal of 25%.

But the other markets subsequently fizzled. In 1979, he sold 24,000 aluminum ladders for farm silos; this year, he will sell but 4,000. Harvester's share of his business has rebounded to over 70%.

For every man working in a roomy Challenge Tool machine shop, four or five machines now are idle. Sitting in his Spartan office and lighting the first of many cigarets, Mr. Redman estimates that it would take five years to rebuild his business if Harvest and Challenge Tool went into bankruptcy proceedings.

Dealers

It's a bleak market for Harvester's 3,000-plus dealers. Sales are sluggish in all product lines, and the competition is brutal for what business remains. To win their share of sales, they must convince customers that Harvester products will still exist even if the company files a bankruptcy proceeding.

In 1981, as Harvester's financial picture darkened, one farm magazine counted 105 Harvester farm-equipment dealers who went out of business, out of 426 dealer failures industrywide. This year, as many as

Please Turn to Page 14, Column 2

Ripple Effects: Many Others Hurt By International Harvester's Woes

Continued From First Page

600 farm dealers will fold in the U.S., one economist estimates.

Of course, some hardy dealers will survive. "We haven't had a single month in the red," boasts Los Angeles Harvester truck dealer Fred Boerner. "If other dealers fold, maybe it will help our business."

Some don't even want to consider the possibilities. "It's like if your wife comes home with clothes on backwards," a Nebraska farm-equipment dealer says. "You wonder if she's playing around, but you look the other way and hope it ain't so."

And some, like Everette Kittle of Waukesha, Wis., are getting out before they're forced out. Harvester's precarious financial condition, its effect on his customers and an unbearable debt burden prompted Mr. Kittle to close the doors of his truck dealership after 27 years. "I'm not flat broke, and that's why I'm quitting now," he says. "I'm tired of fighting."

The economy devastated his trucker customers, Mr. Kittle says. Those who didn't fold were "afraid to buy Harvester in case parts and service dried up in a bankruptcy." (Analysts say that the flow of Harvester equipment and parts would be interrupted only temporarily in that case. And even if a product line such as Harvester trucks was sold, the buyer of the business would probably retain many dealers in order to benefit from customers' loyalty to the dealers.)

Harvester's last good profit-making year was fiscal 1979, and so was Mr. Kittle's. Then, Harvester earned a record $370 million, on $8 billion in sales. In good years like that, Mr. Kittle estimates, he cleared about $120,000. In the past 30 months, however, he lost $250,000.

Outside, the sun-faded walls of the dealership are a lethargic lavender; once they were the royal blue of Harvester's logo. Inside, the plaintive warble of a country-music radio station follows Mr. Kittle as he tours the dealership. The cavernous, near-empty body shop once required two shifts of six mechanics each. On the 10-acre lot that once displayed 40 big rigs, a handful of used trucks remain.

Through the aisles of the once-bustling parts department, the crew-cut Mr. Kittle, whose rotund body inspired a citizens' band radio handle of "Pink Buddha," goes about his glum final chore: packing up 7,500 varieties of parts. These he will return to Harvester for refunds. Then he plans to sell the remaining used trucks and his lot and repay his debts. Whatever is left will be his retirement fund.

At age 57, Mr. Kittle isn't sure what, if any, kind of job he can find, or what he will live on. "At least," he says, "I can face my creditors when I see them on the street."

Employes

In any corporation suffering financial problems, the first wave hits employes. At Harvester, world-wide employment is expected to be near 50,000 by fall, down from 87,000 two years ago. Recently completed negotiations between the company and the United Auto Workers union cut back benefits of those who remain. Employes of 20 years' experience, who had viewed Harvester as a paternalistic, cradle-to-grave security blanket, wonder where the ax will fall next. Productivity is falling and aggravation rising.

"You're trying to do twice as much, twice as fast," one employe complains. "I've kicked my dog a few times."

"You're talking about a stress situation," says a Chicago purchasing manager who worries about suppliers going bankrupt and having to be replaced. "Sometimes it builds up inside and you get a headache. Then, you just have to walk away and think of oceans or outer space, where all this is insignificant."

Even retirees and widows of former employes haven't escaped unscathed. They worry about the pensions, or the value of the Harvester stock they so carefully hoarded during their years with the company. Stockholders' current income has been impeded; Harvester hasn't paid a quarterly dividend for over a year. Marian Smith of Rock Falls, Ill., whose late husband was a cashier at a Harvester plant, has seen her stock decline below $4 a share from $40. "You keep thinking this can't happen to Harvester," she says. Her teaching pension and her husband's Harvester pension keep her going, but the stock-price drop has scared her out of a move to Florida.

Charles Critchley doesn't have to worry about Harvester any more. He is a statistic in the company's "terminated" file. The 38-year-old engineer lost his job in January after spending "half my life, 19.2 years, at Harvester—the only company I ever worked for."

Mr. Critchley is one of the lucky ones, relatively speaking. In just a few months, he found another job, as a body engineer for bus-maker Grumman Flxible Corp. He even makes $1,500 a year more than he did at Harvester, pulling down $37,500 annually.

But Harvester's woes have left him in a lonely limbo, commuting several hundred miles weekly between his Fort Wayne home and the Delaware, Ohio, Grumman plant. During the week, he lives in a $220-a-month efficiency apartment in Delaware; he spends $60 a weekend traveling back to his home. The expenses of his new life style more than eat up his small raise.

"We thought we'd sell our house and start over in Delaware," Mr. Critchley says. "But when we put our house up for sale, no one even looked." Now, the family has a creepy feeling of deja vu, as Grumman starts to cut back its work force.

The last time it happened, at Harvester, Mr. Critchley took the news stoically. A squarely built, subdued man, he recalls brooding silently that night, then going for his usual jog.

In all the turmoil, perhaps the emotional wounds cut deepest. As the family gathers in the driveway for the desultory Sunday farewell ceremony, daughter LeAnn sighs, "Another week of eating frozen dinners and burritos. We can't seem to have a real family dinner with him."

"We've been apart only a few nights at a time in our whole marriage," his wife, Patricia, says. This week, the enforced separation will be particularly hard: Wednesday will be their 20th anniversary. They will have to confine their celebration to the telephone, as usual these days.

Bankruptcy Wave

Business Failures Hit Post-Depression High; Tide Expected to Swell

Slump, High Interest Rates, New Laws Are Factors; A Boon to Some Lawyers

Judges Becoming Frustrated

5/24/82

By Thomas Petzinger Jr.
Staff Reporter of The Wall Street Journal

A bankruptcy epidemic is sweeping American business, and there is no letup in sight.

In the first three months of this year, businesses filed for bankruptcy at the rate of 36 for every hour of the business day. At that pace, the total for the year would be 74,676, the largest in American history.

And the percentage of failing companies has reached a post-Depression high. According to Dun & Bradstreet, business failures are occurring this year at an annual rate of 80 per 10,000 companies. That is 29% higher than last year's rate and within striking distance of 1933's rate of 100 per 10,000.

Economic downturns always claim their corporate victims. The 1970 recession's most notable casualty was Penn Central Transportation Co. Real-estate investment trusts and W.T. Grant Co. were casualties of the 1974 recession. But economists say that it is the variety of bankruptcies, as well as the number, that makes today's shakeout so severe. Bankruptcy filings are occurring in almost every industry.

From AM to Wickes

The list already includes Braniff International Corp., the airline operator; Wickes Cos., the diversified manufacturer and retailer; AM International Inc., the office-equipment maker; Saxon Industries Inc., which converts paper into a variety of products and sells photocopiers; and Lionel Corp., the toy-supermarkets operator and manufacturer of electronic parts. All have filed for reorganization since late February.

It is widely feared that struggling International Harvester Co. will file before long. With $7.04 billion in revenue last fiscal year, the maker of farm machinery, trucks and construction equipment would almost certainly be the biggest U.S. company ever to file a bankruptcy petition.

While Harvester might become the biggest, it probably wouldn't be the last corporate stalwart to file for bankruptcy in this downturn. Edward I. Altman, a finance professor and chairman of the MBA program at New York University, estimates that 200 of the largest 2,000 industrial concerns are potential bankruptcy candidates, based on the weakness of their balance sheets.

The big winners are the law firms and accountants who are coming to dominate the bankruptcy trade. "Business is booming," says Rees W. Morrison, a New York bankruptcy lawyer.

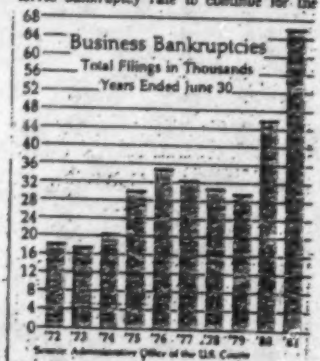
The bankruptcy epidemic goes back to two major events of late 1978: the beginning of the Federal Reserve Board's tight-money policies and a revision of the nation's bankruptcy laws. Since then, business bankruptcies have soared 153%.

The Fed's campaign to reduce inflation through slower monetary growth sent interest rates rocketing; the recession has failed to cool the rates to affordable levels. Many businesses can't earn the profits they need to meet the cost of their swollen debt. Increasingly, bankruptcy is their only way out.

May Outlast Recovery

Congress's revisions made it more tempting than it used to be for companies to file under the bankruptcy code's Chapter 11, which keeps creditors at bay while permitting debtor companies to stay in business. In this year's first quarter, Chapter 11s accounted for 20% of business bankruptcy filings, up from 12% only a year earlier.

Economists and consultants expect the torrid bankruptcy rate to continue for the



rest of the year at least. "There are a lot of companies losing their shirts, and as the economy keeps going sideways, you'll see more companies running out of shirt," says management consultant Thomas E. Dewey Jr.

Even a second-half economic recovery won't immediately reverse the trend, economists say. The early stages of an upturn are punishing to weak businesses, which often overextend to the breaking point in order to gear up output. Business failures surged for nearly a year following the economic turnaround and interest-rate drop that began in 1975.

Transportation deregulation is contributing mightily to the failure rate. Braniff's midnight decision to file for bankruptcy followed cutthroat fare wars and highly leveraged expansion arising from airline deregulation in 1978. Auditors have questioned the future of Texas Air Corp. and its 51%-owned Continental Airlines affiliate. Republic Airlines and Pan American World Airways are among other struggling carriers.

The deregulated trucking companies are

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in much the same situation. Batches of membership invitations mailed from the American Trucking Associations in Washington, D.C., are coming back marked "address unknown" as newly formed cartage concerns join established companies in bankruptcy court. The association knows of 144 established haulers that have been driven from business since mid-1980.

Long-term economic changes will continue to bankrupt companies in a variety of other industries whose future once seemed boundless, economists say. Small oil and gas firms are quickly dropping from sight as energy users mend their wasteful ways. A number of farmers probably won't be able to survive as their rural banks, once a source of cheap funds, continue losing deposits to money-market funds. Some auto-parts, steel and electronics suppliers figure to fall to foreign competition regardless of interest-rate levels in the U.S.

Workers bear much of the burden of a bankruptcy. Four-fifths of all bankruptcy filings are for straight liquidations, in which a company's assets are scattered at auctions and its jobs lost altogether. The piecemeal sale of $350,000 in video gear in this month's liquidation of Advent Corp. cost New Hampshire 200 jobs. The 144 trucking firms known to have gone under since mid-1980 had employed 28,600 persons.

Hundreds of West Virginia coal miners have been stuck with unpaid medical bills this year as their employers went bankrupt without having paid insurance premiums, the United Mine Workers union says. "It's legal thievery is what it is," says David Vidovich, a UMW official in Logan, W.Va. Resentment over such unpaid benefits led to two days of wildcat strikes in February.

Bankruptcies also are burdening the Pension Benefit Guaranty Corp., a government agency that bails out insolvent retirement plans. The agency already is seeking congressional approval for a 130% increase in the $2.60 annual premium it charges U.S. companies for every employe covered by a plan. "A few Harvesters could break the PBGC," says a pension-law lawyer.

A PBGC spokesman denies any danger. But the agency told Congress last week that if mere big companies followed Braniff into bankruptcy, even the 130% premium increase might still leave the PBGC short of funds.

Another result has been to make some big, rich law firms even bigger and richer. One reason is that the 1979 bankruptcy code eliminated a longstanding requirement that a "spirit of economy" prevail when bankruptcy lawyers set their fees. Bankruptcy law, in other words, isn't a charity case any longer.

The Wall Street law firm of Skadden, Arps, Slate, Meagher & Flom, well known for its involvement in corporate takeover cases, raided another big partnership in 1980 to hire Michael Cook, a bankruptcy specialist. Its bankruptcy practice now consists of three partners, 10 associates, four to five paralegals, several clerks and an ever-increasing retainer list. "If you're a bankruptcy lawyer these days and you aren't busy, there's something wrong with you," Mr. Cook says.

A lawyer who participated in the prolonged bankruptcy proceedings of GAC Corp. in Miami asked court approval for fees of $210 an hour for 6,886 hours, a total of $1,450,000. In a ruling last year, Judge Thomas C. Britton allowed the lawyer to collect just $450,000 for his role in the reorganization of the real-estate concern.

Accountants also are participating in a big way. The Chicago auditing firm of Seidman & Seidman is offering "diagnostic services" to help troubled companies decide if they should file for bankruptcy. They often do, and Seidman usually gets to handle the bankruptcy accounting at rates of $100 to $150 an hour for each partner involved in the account.

"It is indeed a marketing tool," says Alexander Knopfler, partner in charge. Seidman takes special precautions to insure that it doesn't lose fees when a client goes into bankruptcy. "In pre-Chapter 11 situations, we always work on the basis of an advance payment," Mr. Knopfler explains.

Frustrated Judges

While some lawyers and accountants benefit, overworked bankruptcy judges just get frustrated. "This used to be an intellectually challenging job, but the seven-day-a-week paper flow has taken all the fun out of it," says Judge Dean Gandy in Dallas. Chapter 11 filings have quadrupled in his court in three years, with "small oil and gas cases being the most common type now," he says.

Minneapolis's bankruptcy judges have begun hearing cases 90 minutes earlier, at 8:30 a.m., and are continuing two hours later, until 6 p.m., because of a growing caseload. "I've got five judges and they're all booked solid," says the bankruptcy court clerk, Timothy Walbridge. Last year's Chapter 11 reorganization of Arctic Enterprises Inc., a snowmobile maker with 18,600 creditors, required special computers. "If we get Republic Airlines in here it would be a wipeout," Mr. Walbridge frets. Republic, citing recent traffic gains, says: "Tell them not to worry. We don't intend to file."

Federal budget cutbacks have cut out nine of the 13 lawyers and clerks helping to administer Chapter 11 cases in the U.S. Trustee's Office in Chicago. "Morale, funds, impetus—you name it, we've lost it," says David Brown, the office's supervising attorney for Chapter 11 cases. The office used to conduct creditors' meetings for each pending case every 30 to 40 days; now it holds only an initial meeting of creditors.

Hope to Limit Damage

Economists hope that the increasing use of Chapter 11 will lessen the damage from bankruptcies.

Chapter 11 can keep jobs and assets in place because it prevents creditors from foreclosing on a debtor, enabling the company to continue operating while it negotiates a plan to pay off its debts at so many cents on the dollar.

The new bankruptcy code makes Chapter 11 a more compelling alternative in a number of ways. It makes it less likely that the courts will oust management in favor of a trustee. It also helps prevent secured creditors from feasting on a debtor's assets and leaving a carcass with little long-term hope for survival.

But the chances of escaping the auction block under Chapter 11 aren't so great. While the changes in the law were designed to improve those chances -- traditionally around 33%—today's weak economic conditions make survival under Chapter 11 more difficult. "To reorganize a business, you have to be able to get some business," says Lawrence King, who teaches at NYU's law school.

Another problem today is that many big companies are waiting until the last minute to file Chapter 11 petitions. By then it is often too late. One reason: As companies pile up losses outside of bankruptcy, they often cannibalize assets that otherwise could be used to reorganize.

Waterloo View

Businessmen in Iowa Are Losing Confidence In Reagan's Program

High Interest Rates Lead List Of Grievances, but Many Don't Fault the President

Rep. Evans's Job Jeopardized

7/23/82

By Timothy D. Schellhardt
Staff Reporter of The Wall Street Journal

WATERLOO, Iowa — The photograph taped to the wall behind Irv Uze's desk shows Ronald Reagan being sworn in as president. The inscription reads: "Thanks to your help, this moment was possible." It is signed by Ronald Reagan.

Thanks in part to President Reagan, Mr. Uze now wants desperately to sell his 38-year-old auto-supply business. A victim of high interest rates and the recession, his company has seen its sales plunge to $1.5 million a year from $4.5 million four years ago. "A lot of small and large businesses in Waterloo are on the brink, and I'll tell you the truth, I'm one of them," Mr. Uze says.

He is losing confidence in the president he helped to raise funds for. "In my heart, I know what he's doing is correct. In my head, I'm not so sure," he declares. "I'm no different from others who believe this economic mess started many years ago and somebody has to stop the runaway horse. On the other hand, everything is working contrary to what we were promised. Interest rates aren't down. The economy isn't rebounding. A person can only stand so much pain before he says, 'Stop, I want out,'" the 64-year-old businessman says.

High Failure Rate

Among the nation's 13 million small-business owners, Mr. Uze has lots of company in his plight and in his fractured feelings about Reaganomics. Business failures, averaging 11 every hour of the business day, are at the highest level since the Depression, according to Dun & Bradstreet, the business-information concern. In the first six months of 1982, failures totaled 11,948, surpassing the full-year figures for 1980 and outpacing the rate in 1933, a year when 19,859 businesses failed.

Persistently high interest rates are killing many debt-laden small businesses that can't generate enough sales in the anemic economy to pay their creditors. Consequently, cracks have emerged in the small-business community's wall of support for President Reagan. This could signal deep political trouble for the administration as well as for Republicans this fall.

Small-business owners were among candidate Reagan's staunchest supporters in 1980, and that solid backing continued last year as the president sought to keep his campaign pledges to cut taxes, slash federal spending, curb inflation and reduce government regulation.

But that was last year. "If interest rates don't come down soon, small businesses will be leaving Reagan in droves," a Washington lobbyist for a small-business trade group predicts. Democratic Rep. John LaFalce of New York, the chairman of a House small-business subcommittee, contends, "there's a sizable segment of small businesses that already have turned their backs on Reagan and that think he's attempted to sell them a bill of goods."

Political Worries

Presidential advisers are understandably worried about any slippage in political support from the small-business community. Administration officials have been struggling to find ways to reduce interest rates, especially on small-business loans. Small Business Administrator James Sanders has set up a panel of outside financial experts to study the matter. "I'm sure the high-interest-rate environment will take its toll politically. That's why we want to feel sure we've explored every avenue to gain some relief from interest rates," Mr. Sanders says.

This northeast Iowa community of 76,000 seems as good a place as any to gauge small-business attitudes toward the Reagan administration and toward economic conditions in general. While many of Waterloo's small manufacturing plants and retail businesses are tied to the depressed farming sector, the city still has a diversified array of businesses, ranging from oil-products concerns and an artillery-shell producer to a major manufacturer of sheet-metal cabinets. Its jobless rate, at 8.5%, is one percentage point below the national average.

Beyond any doubt, small businesses here have been badly battered in the recession. Car dealerships have closed. More than half the stores in several blocks of the downtown business district are empty. Referring to his small-business customers, President R. Scott Fetner of National Bank of Waterloo says, "They're in trouble. Some have already closed. Many are in bankruptcy now."

Lending Problems

Mr. Fetner says he is spending half of his time working on business-loan problems, compared with only 10% a few years ago. "Today, we're just trying to keep them going. Customers will say, 'I can't pay this note but I'll give you the keys to my duplex, to my apartment house.' We say to them, 'We don't want your keys.' We renew the note and give them as much advice as we think will be helpful."

The outlook isn't getting any brighter, Mr. Fetner and other local officials say. "It's going to get worse," the bank president says; Mr. Uze maintains, "You haven't seen anything yet." These pessimists don't anticipate an interest-rate decline that would promote economic recovery.

Many small-business owners here say they are frustrated, trying to understand why things aren't better and how they can stay afloat. Although almost all of them voted for Mr. Reagan over Jimmy Carter,

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whom they blame for getting the country into an economic mess, they are beginning to run out of patience with the president.

"I've seen where he's done some good for the country," says Jim Earnest, the president of E&M Machine Tool Corp. "But the administration said things would be turned around by the first of the year, then the spring of the year, then by summer. Here it is summer, and it seems like things have gotten worse."

His company's revenue slid to $4 million last year from $6.9 million in 1980, and it had a $600,000 loss, its first major deficit. "I've been in business 28 years and this is the toughest time I've ever experienced," the 45-year-old businessman says.

If high interest rates persist, Mr. Earnest contends, "Reagan won't be in office again. And I think they will have a bearing on this fall's election." Chamber of Commerce President Gene Meeker agrees: "Reagan's going to take some hits this election year, and that will hurt Republicans."

Donald Shipanik, whose clothing stores went out of business recently, expresses a thought common among small-business owners here. "You get to a point where you wonder, 'Why not vote for the Democrats?' They may give things away and the deficit may get even bigger. But at least the economy would be stimulated, and from a personal standpoint, that would help me."

Republican Rep. Cooper Evans, who represents this congressional district, is understandably troubled by the travails of his small-business constituency. He is currently considered the underdog in his reelection battle against Lynn Cutler, a Black Hawk County supervisor and a national Democratic Party official.

Effects on a Congressman

"Interest rates—that's *the* factor," says Rep. Evans. "There's a limit to the time some of the small businesses can survive if interest rates stay at their present level. A lot of people will vote their pocketbooks, so the better the economy, the better I'm going to do. The worse the economy, the worse I'll do."

The congressman has suffered politically in one segment of the small-business community—the home builders, who are miffed because he voted recently to sustain President Reagan's veto of a major housing-subsidy plan. The National Association of Home Builders' political-action committee has decided to switch its financial support to challenger Cutler.

Mrs. Cutler, unsurprisingly, is making the economy the issue in this fall's race. She detects a warmer reception from small-business owners, who generally were cool to her bid for office two years ago. "Before, they were friendly but had little tolerance. Now there's a greater willingness to visit. A lot of them are telling me Reagan's economic policies are a failure," she asserts.

For many small-business operators here, Mr. Reagan isn't the only one to blame for economic troubles. Mr. Shipanik, the former clothier, argues that Federal Reserve Chairman Paul Volcker and the other Fed members "could do something for small-business men if they really wanted to." Joan Poe, the president of Standard Distributing Co., a beer wholesaler, blames government bureaucrats, contending, "I don't think it makes much difference who's president." And Mr. Earnest contends that "large money-center banks keep interest rates artificially higher than they should be."

Some Blame Congress

Mr. Fetner, the bank president, says that his small-business customers blame Congress. "If Congress would get the deficit down to $25 billion or $30 billion and cut out a lot of that extra money for defense spending," he says, "this whole country would turn around psychologically." Jewelry-store owner Juanita Flanscha criticizes Congress for clearing "all the giveaway programs going on." She thinks they contribute largely to the huge federal deficits.

Small-business owners here say they haven't benefited much from President Reagan's tax cuts, and some are dismayed at the benefits for large companies. "There's a flaw perhaps in allowing the big firms to capitalize on some of the tax-leasing provisions" of the 1981 tax act, asserts Kenneth Mast, the chairman of Jens Olesen & Sons Construction Co., referring to the controversial law that lets companies buy and sell certain tax benefits. Many large companies have taken advantage of those provisions.

Mr. Mast's company would benefit from the faster depreciation of equipment permitted under the tax act if the industrial and commercial construction business picked up. But that incentive doesn't help much now. "When things are down, you don't buy equipment just to see it depreciate," he says. Chamber of Commerce President Meeker notes, "You've got to make money to benefit from lower taxes, and a lot of these businesses aren't making any."

Small-business owners also say they haven't seen much evidence that the administration's efforts to trim federal regulations and paper work are paying dividends. "It's kind of hard to lay your fingers on it," says machine-tool maker Earnest. Stan Sassmann, the manager of a concern making farm buildings, maintains, "A lot of red tape could still be cut out."

Outlook for Prices

Waterloo's business owners are detecting benefits of deflation, but they doubt that prices will hold steady once the economy perks up. Mr. Mast figures that his costs for building materials and overhead, including utilities, went up only 8% to 10% last year after several years of double-digit inflation. However, he expects an inflationary jolt when business improves. "I'm sure a lot of businessmen figure, 'I have to raise prices to make some money again,' " he says. Mr. Earnest says, "I think you'll have costs going up again, but I hope and pray it's not like it was." He recalls that in 1980, tool-steel prices spurted 75% in a 15-month period.

Most business owners here say they haven't yet lost their optimism about their long-term economic futures. "I sometimes think I'm working for everybody—the government, the bank, you name it—but to be an independent small-business man is the dream of everybody. I wouldn't change it, and good times will return," declares Mr. Shipanik, the former clothing-store proprietor, who now is a restaurateur.

Mrs. Poe, the beer distributor, says, "I'm optimistic about the future. But when the future is going to start, I don't know."